THE CARIBBEAN BASIN INITIATIVE AND THE I.R.C. SECTION 936 INVESTMENT PROGRAM: A UNITED STATES ANSWER TO THE TROUBLED CARIBBEAN REGION

ANILISA G. LUNGER*

1. INTRODUCTION

The Caribbean Basin has been a focus of international strife for over 150 years. Because of the Basin's proximity to the United States, the economic and political stability of the Caribbean Basin has been important to the United States. As a result, the United States has promoted economic development by means of trade programs and aid packages with the goal of economic growth and economic stabilization. Two United States programs, the Caribbean Basin Initiative[1] (CBI) and section 936 of the Internal Revenue Code, are examples of the United States effort.

The Caribbean Basin Initiative was designed to allow qualified Caribbean nations to trade more favorably with the United States. Under this program Caribbean nations receive benefits in the form of aid,[2] trade,[3] and private investment.[4] Principal economic provisions of

* J.D. Candidate, 1988, University of Pennsylvania Law School; B.S., 1985, Bob Jones University.

[1] The Caribbean Basin Initiative (CBI) is the common name of the Caribbean Basin Economic Recovery Act (CBERA), Pub. L. No. 98-67, 97 Stat. 384 (1983) (codified as amended in scattered sections of 19 U.S.C. & 26 U.S.C.).

[2] The CBI includes both economic and military aid. *See Review of the Impact and Effectiveness of the Caribbean Basin Initiative, Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 99th Cong., 2d Sess. 8 (1986) [hereinafter *Review of the CBI*] (statement of Sen. Anthony) (stating that aid had increased from $350 million in 1982 to $1.38 billion in 1985); A. PAYNE, THE INTERNATIONAL CRISIS IN THE CARIBBEAN 58 (1984) (discussing increases in both economic and military aid to the Caribbean Basin).

For references to economic aid, see Cullen, *The Initiative That Wasn't: No 'Marketplace Magic' for the Caribbean Basin*, NEWSWEEK, Dec. 1, 1986, at 44 (the Reagan Administration has spent over $1 billion in economic aid to Caribbean nations since CBI's inception); O'Reilly, *Puerto Rico Offers Funds for CBI*, J. Com., Feb. 11, 1985, at 5A, col. 3 (estimating total economic aid to Caribbean Basin nations in 1985 at $1.24 billion); *see also* CONGRESSIONAL RESEARCH SERVICE, THE ENGLISH-SPEAKING CARIBBEAN: CURRENT CONDITIONS AND IMPLICATIONS FOR U.S. POLICY: REPORT FOR THE SUBCOMM. ON WESTERN HEMISPHERE AFFAIRS OF THE HOUSE COMM. ON FOREIGN AFFAIRS, 99TH CONG., 1ST SESS. 1 (Comm. Print 1985) [hereinafter ENGLISH-SPEAKING CARIBBEAN] (stating that aid to the Eastern Caribbean had risen from $10 million to $50 million over a few years).

Military aid to the Caribbean Basin includes military equipment, money, advice, the CBI include increased economic aid to the region,[5] duty-free treatment of most exports from the Caribbean Basin to the United States,[6] and tax benefits.[7]

Section 936 of the Internal Revenue Code[8] (section 936) was designed to strengthen the economy of Puerto Rico, once considered the "poorhouse of the Caribbean."[9] The main provision of section 936 gives a federal tax credit to United States corporations which actively conduct trade or business in Puerto Rico, sell or exchange substantially all assets in the trade or business, or invest funds from such trade or business in Puerto Rico.[10] The Tax Reform Act of 1986 has extended the availability of this tax credit to the United States Virgin Islands.[11] In addition, the new tax law permits Puerto Rico to provide annually

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and, in some circumstances, military personnel serving as advisors. Erisman, *Contemporary Challenges Confronting U.S. Caribbean Policy*, in THE CARIBBEAN CHALLENGE: U.S. POLICY IN A VOLATILE REGION 3, 18 (H. Erisman ed. 1984) [hereinafter THE CARIBBEAN CHALLENGE]; *see also* Pastor, *Sinking in the Caribbean Basin*, 60 FOREIGN AFF. 1038, 1044 (1982); Tiryakian, *The Military and Security Dimensions of U.S. Caribbean Policy*, in THE CARIBBEAN CHALLENGE, *supra*, at 48. Emergency economic and military aid packages to the Caribbean Basin increased total aid to the region to $825 million in 1982. Boodhoo, *The Economic Dimension of U.S. Caribbean Policy*, in THE CARIBBEAN CHALLENGE, *supra*, at 72, 88.

[3] *See* CBERA, Pub. L. No. 98-67, §§ 211-218, 97 Stat. 384, 384-95 (1983) (codified as amended at 19 U.S.C. §§ 1202, 2701-2705 (Supp. 1985)).

[4] For an overview of various private investment incentives enhanced by the CBI, see Clasen, *The Caribbean Basin Economic Recovery Act and its Implications for Foreign Private Investment*, 16 N.Y.U. J. INT'L L. & POL. 715, 741-47 (1984). Private investment incentives necessarily include introducing technology to the region and employing local people. *See* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 18; Pastor, *supra* note 2, at 1039.

[5] *See supra* note 2.

[6] CBERA, Pub. L. No. 98-67, §§ 211-218, 97 Stat. 384, 384-95 (1983) (codified as amended at 19 U.S.C. §§ 1202, 2701-2705 (Supp. 1985)); *see also* U.S. DEPARTMENT OF COMMERCE, 1987 GUIDEBOOK: CARIBBEAN BASIN INITIATIVE 1 (1986) [hereinafter GUIDEBOOK] ("The centerpiece of the CBI is an innovative one-way free trade area providing customs duty-free access to the U.S. market for 12 years for most categories of products exported from Caribbean Basin countries.").

[7] CBERA, Pub. L. No. 98-67, §§ 221-223, 97 Stat. 384, 395-97 (1983) (codified at 26 U.S.C. §§ 274(h)(6), 7652(c) (Supp. 1985)).

[8] 26 U.S.C.A. § 936 (West 1987).

[9] *See Comprehensive Tax Reform: Hearings Before the House Comm. on Ways and Means, Part 6 of 9*, 99th Cong., 1st Sess. 4976 (1986) [hereinafter *Comprehensive Tax Reform, Part 6*] (statement of Hon. Jaime B. Fuster, Resident Comm'r of Puerto Rico).

[10] 26 U.S.C.A. § 936(a)(1) (West 1987); *see also* Feinschreiber, *Passive Income in the U.S. Possessions*, 9 INT'L TAX J. 27, 28 (1982-1983); *see infra* notes 90-93, 98-105 and accompanying text.

[11] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1275(a)(1), 100 Stat. 2085, 2598 (codified at 26 U.S.C.A. § 936(d)(1) (West 1987)).

American Samoa also receives the § 936 tax credit, and its leaders lobbied vigorously to retain this section in the 1986 Act to protect American Samoa's only industry, tuna canning. *See Comprehensive Tax Reform, Part 6*, *supra* note 9, at 4913 (statement of Hon. Fofo I. F. Sunia, Delegate in Congress from American Samoa).

$100 million of section 936 funds, which are kept on deposit in Puerto Rican development banks, for financing investments in other Caribbean Basin countries.[12]

Despite the apparent United States support for Caribbean development, Caribbean Basin nations continue to struggle with a multitude of political and economic problems. The CBI, despite its good intentions, has often failed to provide the proper incentives for Caribbean economic growth,[13] and Congress has threatened to repeal section 936 twice in the last five years because of United States industries' abuse of the credit.[14] Moreover, economic problems with trade and investment programs in the Caribbean Basin and Puerto Rico often lead to political turmoil; therefore, economic problems must be addressed first in order to ensure a stable political environment.

The section 936 investment incentives to Caribbean Basin nations, coupled with Puerto Rico's Twin Plant Program,[15] attempt to solve some of the region's economic problems by assisting Caribbean nations in setting up complementary operations and joint ventures. These programs also attempt to give Puerto Rico some autonomy by allowing it to release funds to finance development projects in and act as a "big brother" to fellow Caribbean nations. Although the programs are well intentioned and likely to attract business to the Caribbean, many deep-seated problems still remain which the investment incentives cannot solve. In some Caribbean nations, political instability and lack of infrastructure continue to restrict economic progress. Although Puerto Rico is far ahead of its Caribbean neighbors in terms of economic develop-

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[12] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(c)(4), 100 Stat. 2085, 2562 (codified at 26 U.S.C.A. § 936(d)(4) (West 1987)); *see* SUBCOMM. ON OVERSIGHT OF THE HOUSE COMM. ON WAYS AND MEANS, 100TH CONG., 1ST SESS., REPORT ON THE COMM. DELEGATION MISSION TO THE CARIBBEAN BASIN AND RECOMMENDATIONS TO IMPROVE THE EFFECTIVENESS OF THE CARIBBEAN BASIN INITIATIVE 4-5 (Comm. Print 1987) [hereinafter DELEGATION MISSION REPORT]; *Puerto Rico: All About Tax Breaks*, ECONOMIST, Aug. 16, 1986, at 20 [hereinafter *Tax Breaks*]; Wylie, *Production Sharing in the Caribbean Basin*, BUS. AM., July 22, 1985, at 3; *see also infra* notes 141-45 and accompanying text.

[13] Cullen, *supra* note 2, at 44.

[14] *See* 128 CONG. REC. 17,227 (1982) (concerning proposed repeal in 1982); Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth*, in Fed. Taxes (P-H), Bull. No. 52, vol. 2, at 327 (Nov. 1984) (concerning proposed repeal in 1984-85); *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, in Oil & Gas Taxes Natural Resources (P-H), Bull. No. 5, at 307 (May 1985) [hereinafter *President's Tax Proposals*]; *see also Puerto Rico's Governor Lobbies Against Repeal of Possessions Tax Credit*, 25 TAX NOTES, Dec. 17, 1984, at 1061 [hereinafter *Governor Lobbies Against Repeal*]; Sheppard, *Puerto Rico Lobbies to Preserve Possessions Tax Credit*, 26 TAX NOTES, Mar. 18, 1985, at 1074; Timberlake, *Pearlman Defends Proposal to Replace Possessions Tax Credit with Wage Credit*, 26 TAX NOTES, Mar. 25, 1985, at 1184.

[15] *See infra* Section 3.2.2.

ment, it still suffers serious ill effects from poverty and unemployment. Furthermore, section 936 has made Puerto Rico economically dependent on the United States. As a result, other Caribbean nations, although eager to accept Puerto Rican aid, fear that adopting the Puerto Rican model of development could make them similarly dependent on the United States.[16]

This Comment considers the effect of both the Caribbean Basin Initiative and section 936 on Puerto Rico and Caribbean Basin nations. Section 2 examines the origins of the CBI and explains its provisions. Section 3 investigates the historical background of section 936 and discusses its current application. Section 4 analyzes the possible effects of amended section 936 on the Caribbean Basin and investigates recent congressional efforts to improve the CBI. Section 5 examines the impact of section 936 on Puerto Rico and concludes that the continued existence of section 936 fosters Puerto Rican economic and political dependence on the United States. Section 6 suggests ways to improve Puerto Rico's economic and political status so that Puerto Rico may remain a leader of Caribbean Basin development.

2. THE CARIBBEAN BASIN INITIATIVE

2.1. *The Historical Perspective*

The Caribbean Basin comprises all of the islands in the Caribbean Sea, as well as the Central American and some South American nations.[17] This region has historically been dominated by European colonial powers.[18] The languages of the small countries reflect Spanish,

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[16] Braveboy-Wagner, *The Politics of Developmentalism: U.S. Policy Toward Jamaica*, in THE CARIBBEAN CHALLENGE, *supra* note 2, at 160, 166-67.

[17] ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 2 ("[T]he Caribbean stretches from Belize in Central America in an arc through Cuba, Jamaica, Haiti, the Dominican Republic, and Puerto Rico, and then on through the smaller islands of the Eastern Caribbean and on to Guyana, Suriname, and French Guiana in South America."). For statistics on the size, population, and Gross National Product of Caribbean Basin nations, see *id.* at 4-5; GUIDEBOOK, *supra* note 6, at 19-37; A. PAYNE, *supra* note 2, at 167-70. The concept of a "Caribbean Basin" exists for two reasons: (1) the problems of development in these countries are similar and interrelated, and (2) the countries of the region pose a similar challenge to the United States in its development of a coherent policy toward the region. Pastor, *supra* note 2, at 1040. *But see* Lowenthal, *The Insular Caribbean as a Crucial Test for U.S. Policy*, in THE CARIBBEAN CHALLENGE, *supra* note 2, at 183, 195 (stating that it is unrealistic to lump the Caribbean islands with Central America because of their historical and cultural differences).

[18] The Spanish-speaking countries of the region include the Central American countries, Puerto Rico, Cuba, and the Dominican Republic; Haiti is predominantly French, and the Netherlands Antilles are Dutch, with the remaining nations predominantly English. For a history of the colonization of the Caribbean Basin, see E. WIL-

English, French, and Dutch influence in the early colonial era.[19] In the 1800s and 1900s, many of the Caribbean and Central American countries, like most of their South American neighbors, gained their independence from European colonial nations.[20] These European powers, however, often continued to influence their former colonies through language and culture.[21]

The United States became a key player in the Caribbean Basin in 1898, during the Spanish-American War. After losing this conflict to the United States, Spain relinquished its claim to Cuba and ceded Puerto Rico[22] to the United States.[23] The United States later gave Cuba its independence[24] and made Puerto Rico a United States territory,[25] and later a Commonwealth.[26] In the early 1900s, the United States

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LIAMS, FROM COLUMBUS TO CASTRO: THE HISTORY OF THE CARIBBEAN (1984); *see also* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 2; GUIDEBOOK, *supra* note 6, at 20 ("National languages include Spanish, French, Creole, and Dutch, but English generally can be used to conduct business throughout the region."); Pastor, *supra* note 2, at 1040.

[19] *See* A. PAYNE, *supra* note 2, at 6.

[20] *See* THE AFTERMATH OF SOVEREIGNTY: WEST INDIAN PERSPECTIVES xiii (D. Lowenthal & L. Comitas eds. 1973) [hereinafter AFTERMATH]; *see also* Braveboy-Wagner, *supra* note 16, at 166 (discussing the British colonies' attainment of independence from England during the period 1962-1966).

[21] *See* Lowenthal, *supra* note 17, at 186 ("All of the Caribbean countries . . . bear the mark of centuries of colonial rule and of plantation societies."); *see also* AFTERMATH, *supra* note 20, at xiii-xv; A. PAYNE, *supra* note 2, at 39; Odell, *The Caribbean and the Outside World: Geopolitical Considerations*, in PATTERNS OF FOREIGN INFLUENCE IN THE CARIBBEAN 18, 21 (E. De Kadt ed. 1972) [hereinafter PATTERNS]. *See generally* Hall, *The Ex-Colonial Society in Jamaica*, in PATTERNS, *supra*, at 32 (discussing Britain's influence on Jamaica throughout the nineteenth and most of the twentieth centuries); Henfrey, *Foreign Influence in Guyana: The Struggle for Independence*, in PATTERNS, *supra*, at 49 (discussing Britain's influence on Guyana, both before and after independence). Other essays in PATTERNS consider European influence in the French Antilles, the Dutch Caribbean, and Cuba.

[22] For the history of Puerto Rico prior to 1898, see García-Passalacqua, *Intertwined Futures: Puerto Rico, the United States, the Caribbean Basin, and Central America*, 9 FLETCHER F. 269, 270-72 (1985); Tansill, *Puerto Rico: Independence or Statehood?*, 41 REVISTA DEL COLEGIO DE ABOGADOS DE PUERTO RICO [REV. COL. AB. P.R.] 79, 79-83 (1980).

[23] Treaty of Paris, Dec. 10, 1898, United States-Spain, art. II, 30 Stat. 1754, 1755, T.S. No. 343. *See* J. N. CORTADA & J. W. CORTADA, U.S. FOREIGN POLICY IN THE CARIBBEAN, CUBA, AND CENTRAL AMERICA 41 (1985); L. LANGLEY, THE UNITED STATES AND THE CARIBBEAN IN THE TWENTIETH CENTURY 3 (rev. ed. 1985); Geyls, *The Territorial Status of Puerto Rico and Its Effects on the Political Future of the Island*, 11 REVISTA JURÍDICA DE LA UNIVERSIDAD INTERAMERICANA DE PUERTO RICO [REV. JUR. U.I.P.R.] 385, 407 (1977).

[24] Although Cuba gained its independence in 1902, from 1902 to 1909 it was a protectorate of the United States. J. N. CORTADA & J. W. CORTADA, *supra* note 23, at 69; L. LANGLEY, *supra* note 23, at 38.

[25] *See* Tansill, *supra* note 22, at 84.

[26] *See infra* note 245 and accompanying text; *see also* Tansill, *supra* note 22, at 91-93.

became more involved in the Caribbean Basin by building the Panama Canal and setting up the Canal Zone in Panama as a United States possession.[27] United States holdings in the Caribbean Basin presently include the possessions of Puerto Rico and the United States Virgin Islands,[28] the Panama Canal Zone,[29] and a naval base at Guantanamo Bay in Cuba.[30]

In the twentieth century, the Caribbean and Central American nations have been plagued by political and economic problems. In Cuba, the government changed from democracy to military dictatorship to communist dictatorship under Fidel Castro.[31] Other countries, such as Haiti,[32] Guatemala,[33] and Nicaragua,[34] have suffered under oppressive regimes. Only a few Caribbean Basin nations have had politically stable governments.[35]

Economically, Latin American nations have suffered acutely from increasing population levels,[36] dependence upon the production of a few

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[27] The Isthmian Canal Convention, Nov. 18, 1903, United States-Panama, art. II, 33 Stat. 2234, 2234-35, T.S. No. 431 (repealed in Panama Canal Treaty, discussed *infra* note 29). *See generally* L. Langley, *supra* note 23, at 30 (discussing the historical background of the Panama Canal).

[28] *See* Pastor, *supra* note 2, at 1039.

[29] To be ceded back to Panama "at noon, Panama time, December 31, 1999." Panama Canal Treaty, Sept. 7, 1977, United States-Panama, art. II, T.I.A.S. No. 10,030, at 12. For a discussion of the historical background to the Panama Canal Treaty, see L. LANGLEY, *supra* note 23, at 277-82.

[30] *See* Lowenthal, *supra* note 17, at 189; 131 CONG. REC. E2168 (daily ed. May 14, 1985). The United States also has a military test center in the Bahamas. A. PAYNE, *supra* note 2, at 37.

[31] *See generally* L. LANGLEY, *supra* note 23, at 211-33 (discussing the background of the Cuban Revolution, the collapse of the Batista regime and Castro's rise to power, the Bay of Pigs incident, and the Cuban missile crisis).

[32] Haiti's political problems in the twentieth century date back as far as 1915. *Id.* at 72. Political problems reappeared in the late 1940s, and continued under the Duvaliers. *Id.* at 235.

[33] Jacobo Arbenz's leftist government was considered a viable communist threat in 1954. *Id.* at 205-10. Moreover, "since 1978 Guatemala has ranked consistently among the governments most notorious for state terrorism." *Id.* at 289. *See generally* Hayes, *Coping with Problems that Have No Solutions: Political Change in El Salvador and Guatemala*, in CONFRONTATION IN THE CARIBBEAN BASIN: INTERNATIONAL PERSPECTIVES ON SECURITY, SOVEREIGNTY AND SURVIVAL 13 (A. Adelman & R. Reading eds. 1984) [hereinafter CONFRONTATION].

[34] Nicaragua was plagued with civil wars from 1926 to 1933. L. LANGLEY, *supra* note 23, at 117-24. Its political problems continued under the Somoza regime, and led to the fall of Somoza and the Sandinista victory. *Id.* at 203-05, 282-86.

[35] *See* Adelman, *Introduction*, in CONFRONTATION, *supra* note 33, at 3; Harrison, *U.S. Economic Aid Policy in Central America*, 8 FLETCHER F. 33, 38-39. *See generally* L. LANGLEY, *supra* note 23 (describing the history of the Caribbean in the twentieth century).

[36] Pastor, *supra* note 2, at 1041; *see* Comment, *The Caribbean Basin Initiative and U.S. Countervailing Duty Law: One Man's Development Incentive May Be Another's Export Subsidy*, 6 J.L. & COM. 253, 256 (1986).

export commodities which are tied to the volatile world market,[37] unemployment,[38] and poverty.[39] Because most of the Caribbean islands and Central American countries are small and unable to produce basic agricultural crops, they also must import vast quantities of food. This heavy importation leads to substantial trade deficits.[40]

The United States first began giving aid to struggling Caribbean Basin nations during World War II.[41] This aid, primarily in the form of development assistance programs, was directed principally toward Central American nations. Its purpose was to assure a constant flow of raw materials from the region to assist in the war effort.[42] Economic aid to the region continued after the war by means of President Truman's Point IV program and the Export-Import Bank.[43] Motivated by the Cuban Revolution and increasing economic turmoil in the Caribbean, President Kennedy launched the Alliance for Progress in 1960.[44] Objectives of the Alliance included increasing economic growth in the Caribbean, modifying the established infrastructures of Latin American countries, and accelerating democratization in the region.[45] Although

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[37] *See infra* note 55 and accompanying text; A. PAYNE, *supra* note 2, at 9; Pastor, *supra* note 2, at 1040-41.

[38] Unemployment has been a chronic problem in the Caribbean Basin, with levels generally fluctuating around the 20% range. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 33; *see* A. PAYNE, *supra* note 2, at 10; Pastor, *supra* note 2, at 1041; *see also* Will, *The Struggle for Influence and Survival: The United States-Microstate Caribbean Interface*, in COLOSSUS CHALLENGED: THE STRUGGLE FOR CARIBBEAN INFLUENCE 199, 204 (H. Crisman & J. Martz eds. 1982) [hereinafter COLOSSUS CHALLENGED] (discussing the seriousness of unemployment among Caribbean youth).

[39] *See* A. PAYNE, *supra* note 2, at 17; Erisman, *Contemporary Challenges Confronting U.S. Caribbean Policy*, in THE CARIBBEAN CHALLENGE, *supra* note 2, at 3, 15.

[40] The inability of Caribbean nations to produce agricultural staples is a result of both the unsuitability of their land for agriculture and socio-political problems resulting from agriculture's historical association with slavery. *See Dilemmas of Caribbean Development: An Interview with G. Arthur Brown*, 9 FLETCHER F. 255, 263 (1985) [hereinafter *Dilemmas of Caribbean Development*] (stating that one of the causes of the food import problem is that Caribbean nations do not produce and have never produced the staples of the Caribbean diet); STAFF OF THE HOUSE COMM. ON FOREIGN AFFAIRS, 97TH CONG., 2D SESS., EASTERN CARIBBEAN: REPORT OF A STAFF STUDY MISSION TO THE DOMINICAN REPUBLIC, ANTIGUA, DOMINICA, BARBADOS AND ST. VINCENT 12-15 (Comm. Print 1982) [hereinafter EASTERN CARIBBEAN REPORT] (discussing agricultural problems in Antigua, Dominica and St. Vincent); *see also infra* notes 179-80 and accompanying text.

[41] *See* L. LANGLEY, *supra* note 23, at 165, 179-81; Harrison, *supra* note 35, at 33.

[42] *See* Harrison, *supra* note 35, at 33-34.

[43] Under President Truman's Point IV program, the region received technical assistance, particularly in health and education. *Id.* at 34. The Export-Import Bank did some capital lending, principally for highways. *Id.*

[44] *See* L. LANGLEY, *supra* note 23, at 234; Harrison, *supra* note 35, at 34.

[45] *See* Bledel, *The Latin American Development Process and the New Legislative Trends*, 10 GA. J. INT'L & COMP. L. 325, 329 (1980).

the Alliance for Progress was not successful, it laid the basic groundwork for Caribbean and Central American economic development and increased worldwide awareness of the problems in the region.[46]

The Caribbean Basin nations themselves were aware of the political and economic problems they faced and recognized the importance of regional integration. In 1960, the Central American Common Market[47] (CACM) was formed to reduce trade barriers between member nations and to determine common external tariffs for the rest of the world.[48] In 1967, several Eastern Caribbean nations founded the Caribbean Free Trade Association (CARIFTA),[49] which was replaced in 1973 by the Caribbean Common Market (CARICOM).[50] The goals of both CARICOM and CACM are very similar: to create favorable trade agreements between member nations and to achieve regional integration in order to present a united front to the rest of the trading world.[51] Although political and economic problems often have made it difficult for CACM and CARICOM to meet their goals,[52] other trading groups, having recognized the importance of regional economic cooperation, have assisted Caribbean nations economically.[53]

Regional integration is important to the development of the Caribbean Basin; however, economic communities alone have not been able

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[46] *Id.* at 330.

[47] Central American Agreement on the Equalization of Import Duties and Charges (with Schedules) and Protocol Concerning a Central American Preferential Tariff, Sept. 1, 1959 & Dec. 13, 1960, 454 U.N.T.S. 6542. The member nations of CACM were Costa Rica, Guatemala, El Salvador, Honduras, and Nicaragua.

[48] J. N. CORTADA & J. W. CORTADA, *supra* note 23, at 96. For problems with CACM, see Harrison, *supra* note 35, at 35.

[49] Agreement Establishing the Caribbean Free Trade Association, Dec. 15, 1965, 772 U.N.T.S. 11,011. The member nations included Antigua, Barbados, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia, St. Vincent, and Trinidad and Tobago. *Id.* at 110. CARIFTA rose out of the West Indies Federation, which dissolved in 1962. For an analysis of the rise and fall of the West Indies Federation, see H. SPRINGER, REFLECTIONS ON THE FAILURE OF THE FIRST WEST INDIES FEDERATION (1962); Barrett, *The Rise and Fall of the Federation of the West Indies*, in 1 READINGS IN CARIBBEAN HISTORY AND ECONOMICS: AN INTRODUCTION TO THE REGION 292 (R. Delson ed. 1981); Will, *supra* note 38, at 199.

[50] Treaty Establishing the Caribbean Community, July 4, 1973, 12 I.L.M. 1035. Member nations include all the members of CARIFTA, as well as Bahamas and Belize.

[51] *See* L. LANGLEY, *supra* note 23, at 272; A. PAYNE, *supra* note 2, at 138-41.

[52] The economic problems of the 1970s created balance of payment problems in most Caribbean nations, frustrating the development of CARICOM as a world market trader. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 16.

[53] This trend is recognized particularly by the provisions of the European Economic Community's (EEC) Lomé Convention of February 1975, *reprinted in* 14 I.L.M. 595 (1975). *See* O'Connell, *The Caribbean Community: Economic Integration in the Commonwealth Caribbean*, 11 J. INT'L L. & ECON. 35, 55-57 (1976). The Lomé Convention, which extends duty-free treatment to several Caribbean nations, was renewed in December 1984 for five years. GUIDEBOOK, *supra* note 6, at 9.

to solve all of the inherent problems of these nations. In the 1970s, the price of oil rose, hurting many of the Caribbean nations which depended on imported oil for manufacturing.[54] At the same time, demand for staple Caribbean commodities, such as coffee, sugar, and bauxite, was decreasing.[55] This economic condition, coupled with natural disasters,[56] political unrest,[57] worldwide recession,[58] and high interest rates[59] practically halted economic growth in the Caribbean Basin and made it very difficult for nations to pay their international debts.[60] During the late 1970s, the United States increased its aid to Caribbean and Central American nations from under $100 million in 1975 to over $400 mil-

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[54] The oil crisis was particularly harmful to nations of the Caribbean region because of their fragile island economies. In the early 1970s, at the time of the first oil shock, Caribbean nations were forced to transfer their attention from increasing their exports to simply trying to keep their national economies afloat. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 10. For an analysis of all the economic and political repercussions of the oil crisis, see A. PAYNE, *supra* note 2, at 11-33. This discussion points out the likelihood that economic crisis will lead to political turmoil. *See infra* note 57.

The Caribbean's continued dependence on oil is adversely affected by the present world oil glut which has led to a reduction in efforts to search for and refine oil in the oil-rich Caribbean nations. *See* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 32 (discussing Exxon's shutdown of its Aruba refining plant).

[55] The economic dependence of the Caribbean region on volatile world commodities markets for export earnings is one of the main causes of its economic instability. *See* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 11. The problem of decreased demand for Caribbean commodities, especially bauxite, has not improved in the 1980s. *Dilemmas of Caribbean Development*, *supra* note 40, at 256-57.

[56] *See, e.g.*, EASTERN CARIBBEAN REPORT, *supra* note 40, at 4 (discussing the havoc Hurricanes David and Frederick wreaked on the Dominican Republic in August 1979); Martin, *Puerto Rico's Economy: History and Prospects*, BUS. AM., Nov. 25, 1985, at 9 (discussing the October 1985 flood and landslide damage in Puerto Rico); Will, *supra* note 38, at 204 (discussing the devastation of the 1980 Eastern Caribbean banana crop by Hurricane Allen).

[57] Political instability often arises from economic instability, particularly in the Caribbean Basin. When the Dominican Republic and Jamaica removed subsidies from commodities, riots and demonstrations broke out. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 12. Security threats to the region are often a by-product of economic turmoil. *See id.* at 16 ("Economic insecurity . . . threatens internal security."). *But see id.* at 22 (statement of Carl Stone) (claiming that disturbances are caused by political, rather than economic hardship).

[58] Due to its reliance on a few staple exports, the Caribbean Basin depends on foreign price stability for its economic well-being. In the late 1970s, inflation caused prices of Caribbean exports to rise dramatically, with the result that importing countries placed restrictions on those exported goods. During this worldwide recession, the Caribbean Basin was particularly hard hit: in the Eastern Caribbean alone, the balance of payment deficit rose from "$80 million in 1977 to $300 million in 1981." ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 32.

[59] *See* A. PAYNE, *supra* note 2, at 154; *Dilemmas of Caribbean Development*, *supra* note 40, at 260; Pastor, *supra* note 2, at 1041.

[60] *See Dilemmas of Caribbean Development*, *supra* note 40, at 259; Pastor, *supra* note 2, at 1041.

lion in 1980.[61]

2.2. *Provisions of the Caribbean Basin Initiative*

In order to alleviate the economic problems of the region, and to address the increasing political unrest in El Salvador,[62] Nicaragua,[63] and Grenada,[64] the Reagan Administration proposed the Caribbean Basin Initiative in 1982.[65] This plan was an attempt to solve two major problems of the region: inadequate economic development and political instability.[66] On August 5, 1983, Congress approved legislation giving the President authority to grant duty-free treatment to certain Caribbean Basin nations.[67]

The trade provisions of the CBI were designed to operate for twelve years.[68] The trade provisions[69] are divided into two sections: duty-free treatment on exports from CBI nations[70] and tax provisions dealing mainly with business conventions in the Caribbean Basin.[71]

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[61] *See* Pastor, *supra* note 2, at 1048.

[62] *See* Valenta, *Soviet Policy and the Crisis in the Caribbean*, in COLOSSUS CHALLENGED, *supra* note 38, at 47, 68; Hayes, in CONFRONTATION, *supra* note 33, at 13.

[63] *See supra* note 34; A. PAYNE, *supra* note 2, at 48; Harrison, *supra* note 35, at 37; Sims, *Revolutionary Nicaragua: Dilemmas Confronting Sandinistas and North Americans*, in CONFRONTATION, *supra* note 33, at 51; Valenta, *supra* note 62, at 63.

[64] Under the left-wing New Jewel Movement, Grenada was considered such a communist threat prior to United States intervention that Grenada was almost excluded from CBI recognition. A. PAYNE, *supra* note 2, at 18-20, 63.

[65] *See supra* note 1 and accompanying text; Pastor, *supra* note 2, at 1038-39; *see also id.* at 1044 ("The well-being and security of our neighbors in this region are in our own vital interests.").

[66] *See The Caribbean Basin Initiative: Hearings Before the Subcomm. on Inter-American Affairs of the House Comm. on Foreign Affairs*, 97th Cong., 1st Sess. 192 (1981) [hereinafter *Hearings on the CBI*] (statement of E. T. York); Pastor, *supra* note 2, at 1038-39.

[67] 129 CONG. REC. S8580 (1983) (rollcall vote no. 157); President's Statement on the Caribbean Basin Initiative, 1983 PUB. PAPERS 1037 (July 14, 1983), *reprinted in* DEP'T ST. BULL., Sept. 1983, at 85.

[68] 19 U.S.C. § 2706 (Supp. 1985); GUIDEBOOK, *supra* note 6, at 1; Pastor, *supra* note 2, at 1044.

[69] For analysis of the CBI, see DELEGATION MISSION REPORT, *supra* note 12, at 1-6; GUIDEBOOK, *supra* note 6, at 3-7; A. PAYNE, *supra* note 2, at 56-59; Clasen, *supra* note 4, at 721-41; Fiszman, *Foreign Investment Law: Encouragement versus Restraint — Mexico, Cuba, and the Caribbean Basin Initiative*, 8 HASTINGS INT'L & COMP. L. REV. 147, 174 (1985); *Recent Developments: International Trade: Elimination of Tariffs on Caribbean Products — Caribbean Basin Economic Recovery Act*, 25 HARV. INT'L L.J. 245 (1984) [hereinafter *Recent Developments*]; Travis, *Will the Caribbean Basin Initiative Really Work?*, AM. SHIPPER, Nov. 1983, at 76.

[70] *See supra* note 6 and accompanying text.

[71] *See supra* note 7 and accompanying text. Additional portions of CBERA addressing tax issues include § 221 (codified as amended at 26 U.S.C. § 7652(c) (Supp. 1985)) (providing protection for the Puerto Rican and United States Virgin Islands rum industries by requiring the United States Treasury to pay all excise taxes on all

These sections are preceded by a section establishing prerequisites to becoming a CBI beneficiary country.[72]

Eligible beneficiary countries include all Central American nations, some South American nations, and most Caribbean nations (excluding United States possessions and Cuba).[73] The CBI imposes seven disqualifying conditions which prevent a country from being designated a beneficiary.[74] The President's decision to confer beneficiary country status may also be affected by eleven additional provisions.[75]

Products eligible for duty-free treatment under the CBI include all articles (1) sold in the United States, (2) of whose cost or value at least thirty-five percent is produced in the Caribbean Basin, and (3) which are not otherwise excluded in the CBI.[76] Items specifically excluded

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rum imported into the United States into the treasuries of Puerto Rico and the Virgin Islands) and § 223 (requiring the Secretary of the Treasury to report to Congress any Caribbean Basin tax havens, drug trafficking, or other illegal activity).

[72] 19 U.S.C. § 2702 (Supp. 1985).

[73] 19 U.S.C. § 2702(a)-(b) (Supp. 1985). As of October 1986, 22 Caribbean Basin nations had achieved CBI beneficiary status: Antigua and Barbuda, Aruba, The Bahamas, Barbados, Belize, Costa Rica, Dominica, the Dominican Republic, El Salvador, Grenada, Guatemala, Haiti, Honduras, Jamaica, Montserrat, the Netherlands Antilles, Panama, Saint-Christopher Nevis, Saint Lucia, Saint Vincent and the Grenadines, Trinidad and Tobago, and British Virgin Islands. Six additional nations are eligible for CBI beneficiary status, but have not been so designated: Anguilla, Cayman Islands, Guyana, Nicaragua, Suriname, and Turks and Caicos Islands. GUIDEBOOK, *supra* note 6, at iv.

[74] 19 U.S.C. § 2702(b)(1)-(7) (Supp. 1985); *see also Recent Developments*, *supra* note 69, at 246-47. The seven conditions which prevent a country from becoming a beneficiary of the CBI are: (1) having trade policies which harm United States commerce; (2) failing to cooperate with the United States in controlling the narcotics trade; (3) refusing to agree to extradition of United States citizens; (4) becoming a communist country; (5) seizing ownership of the property of a United States citizen or corporation; (6) failing to recognize arbitral awards in favor of United States citizens and corporations; and (7) infringing on broadcasts of United States copyrighted material. The first three conditions are absolutely prohibited, while the last four may be waived if the President determines that it is in the national interest of the United States to designate the country a beneficiary.

[75] 19 U.S.C. § 2702(c) (Supp. 1985). These 11 additional provisions include: (1) the country's expression of a desire to become a beneficiary; (2) the economic condition of the country; (3) the granting of fair and reasonable access to markets and resources of that country; (4) the agreement of the country to follow accepted rules of international trade; (5) the degree to which the country uses distortionary international trade practices, including export subsidies and performance requirements and local content requirements; (6) the contribution of the country's trade policies to the revitalization of the region as a whole; (7) the country's self-help remedies to improve its economic development; (8) the condition of workplaces in the country and rights of workers to bargain collectively; (9) the extent to which the country's laws protect the patent, trademark, and copyright rights of foreign nationals; (10) the extent to which the country's laws prohibit the broadcasting of copyrighted material belonging to United States citizens; and (11) the extent to which the country is willing to cooperate with the United States to enforce CBI provisions.

[76] 19 U.S.C. § 2703(a) (Supp. 1985). For purposes of determining the percentage of the article's appraised cost or value, Puerto Rico and the United States Virgin Is-

from duty-free treatment are textile and apparel articles,[77] footwear and leather goods,[78] tuna,[79] petroleum,[80] and watches and watch parts.[81] In addition, duty-free treatment may be suspended on Caribbean sugar if importation interferes with United States domestic sugar production.[82]

Subtitle B of the original CBI embodies the tax provisions that apply to the CBI constituents.[83] The major tax provision deals with the treatment of business conventions in the Caribbean Basin.[84] Under this provision, a business can deduct the expenses of a convention held in a Caribbean Basin country as long as (1) the CBI country has filed an exchange-of-information agreement with the United States, and (2) the CBI country does not by means of its tax laws discriminate against

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lands are included as beneficiary countries. In addition, the 35% domestic production requirement may be reduced by as much as 15% by any materials originating within the United States. *Id.* § 2703(a)(1). The CBI country must either wholly produce the product or substantially manufacture a new or different article ("[S]imple combining or packaging operations, or . . . mere dilution with water or . . . another substance that does not materially alter the characteristics of the article" are not eligible for duty-free treatment.). *Id.* § 2703(a)(2)(A)-(B); *see The Caribbean Basin Initiative and U.S. Minority Participation: Hearings Before the Subcomms. on International Economic Policy and Trade and on Western Hemisphere Affairs of the House Comm. on Foreign Affairs*, 99th Cong., 1st Sess. 15 (1985) [hereinafter *CBI and U.S. Minority Participation*]; *see also* 131 Cong. Rec. S2507 (daily ed. Mar. 5, 1985) (statement of Sen. Dole) (stating that simply dehydrating one substance to produce ethanol should not qualify the product for duty-free treatment).

[77] 19 U.S.C. § 2703(b)(1) (Supp. 1985); *see also infra* notes 173-76 and accompanying text.

[78] 19 U.S.C. § 2703(b)(2) (Supp. 1985).

[79] 19 U.S.C. § 2703(b)(3) (Supp. 1985). Tuna was excluded to protect the tuna industries in Puerto Rico and American Samoa. *See* Clasen, *supra* note 4, at 732.

[80] 19 U.S.C. § 2703(b)(4) (Supp. 1985). Oil was excluded primarily because duty-free treatment of oil would probably not benefit CBI countries; rather, it would only benefit United States oil companies which already possess refineries in the Caribbean. *See* Clasen, *supra* note 4, at 732-33.

[81] 19 U.S.C. § 2703(b)(5) (Supp. 1985). This restriction only applies if the watch contains any material manufactured in a communist country. *See* Clasen, *supra* note 4, at 733.

[82] 19 U.S.C. § 2703(c) (Supp. 1985); *see also* Clasen, *supra* note 4, at 733-34; Pastor, *supra* note 2, at 1046 ("[T]he Administration proposed to give sugar producers [in the Caribbean Basin] a slight preference over other foreign exporters, but not so much as to [allow them to] compete equally with U.S. sugar growers.").

[83] During CBI negotiations, the President and Treasury Department considered many tax incentives, including a five-year investment tax credit. *Details Still Lacking on Caribbean Tax Incentive*, 14 Tax Notes, Mar. 8, 1982, at 640; Field, *Treasury Spells Out New Caribbean Tax Incentives*, 14 Tax Notes, Mar. 22, 1982, at 774. Other incentives considered included wage subsidies and tax sparing. *Id.* at 776 ("Tax sparing allows a credit against domestic taxes for taxes an investor is spared from paying when a foreign country reduces or waives tax liabilities as an investment incentive."). These proposals, however, failed in Congress.

[84] 26 U.S.C. § 274(h)(6) (Supp. 1985).

conventions held within the United States.[85]

In addition to the trade provisions, the United States increased its economic and military aid to the region; in 1982, Congress approved emergency aid of $350 million for both private investment and public development projects,[86] and such aid has increased annually since that time. Other provisions of the CBI include special access to United States markets for some CBI apparel manufacturers and enlarged access to the United States government procurement market.[87] Increased aid to CBI countries to improve development and infrastructures, coupled with the attractiveness of duty-free trade, were expected to attract United States investment to the region.[88]

3. The Possessions Tax Credit

3.1. *Historical Background*

United States possessions first received preferential tax treatment under the Revenue Act of 1921.[89] In 1948, Puerto Rico improved tax incentives for investment on the island by coupling federal tax exemption on United States corporations[90] with various Puerto Rican tax exemptions.[91] This program, known as "Operation Bootstrap,"[92] made

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[85] 26 U.S.C. § 274(h)(6)(A) (Supp. 1985). The purpose of exchange-of-information agreements is to force Caribbean nations such as the Bahamas to choose between the benefits of the CBI and traditional benefits derived from operating as tax havens for United States citizens. *See* Field, *supra* note 83, at 775.

[86] *See supra* note 2; *see also* Braveboy-Wagner, *supra* note 16, at 168.

[87] *Review of the CBI*, *supra* note 2, at 24-26; *see also* Guidebook, *supra* note 6, at 1. The special access for textile manufacturers is greater if the apparel is made from material manufactured and cut in the United States. *Review of the CBI*, *supra* note 2, at 25. For a discussion concerning ways to improve the government procurement concept, see *id.* at 488-89 (statement of B. Zagaris and C.G. Papanizas).

[88] *Hearings on the CBI*, *supra* note 66, at 207-09.

[89] Revenue Act of 1921, ch. 136, § 262, 42 Stat. 227, 314. This Act was passed primarily to aid the Philippines in its pre-independence days. *See* Comment, *Puerto Rico's Possessions Corporations: Do the TEFRA Amendments Go Too Far?*, 1984 Wis. L. Rev. 531, 533. For a general analysis of § 936, see Costas Elena, *I.R.C. Section 936 and Fomento Income Tax Exemptions in Puerto Rico* (pts. 1-4), 40 Rev. Col. Ab. P.R. 563 (1979), 41 Rev. Col. Ab. P.R. 101, 225 (1980), 42 Rev. Col. Ab. P.R. 611 (1981).

[90] Section 936 and its predecessor, § 931, differ from most other Internal Revenue Service treatment of foreign income in that § 936 grants a credit equal to the tax attributable to the possessions corporation. Posessions corporations are almost always subsidiaries of multinational corporations, which can achieve compliance with § 936 by careful tax planning. *See* Costas Elena, pt. 1, *supra* note 89, at 577. Therefore, rather than using tax credits to offset taxes paid in other countries, § 936 in effect reduces tax on that income to zero. *See id.* at 587 ("For this reason the tax sparing of I.R.C. section 936(a) is highly abnormal."); Romero, *CBI Not Likely to Benefit from Section 936*, 30 Tax Notes, Feb. 10, 1986, at 547 (calling § 936 a "phantom tax credit").

[91] Industrial Tax Exemption Act of 1948, No. 184, 1948 P.R. Laws 482 (expired 1962). This law was amended by the Puerto Rico Industrial Incentive Act of 1954, No.

Puerto Rico a model for Caribbean development. This tax break resulted in a surge of United States corporations investing capital[93] and building manufacturing plants in Puerto Rico, particularly in labor-intensive industries.[94] Puerto Rico continued to reap the benefits of United States investment throughout the 1950s and 1960s.[95]

In the early 1970s, however, it became apparent that the Possessions Tax Credit needed to be greatly revised in order for Puerto Rico to receive any further economic benefit from its preferential tax treatment. United States corporations were investing the profits from the possessions tax deduction in foreign banks rather than in Puerto Rican banks.[96] This deprived Puerto Rico of the capital it needed to improve its infrastructure and to undertake domestic investment. In addition, because possessions corporations could not repatriate income to their United States parent corporations and continue to receive benefits under section 936, these parent corporations had an incentive to liquidate their possessions subsidiaries rather than to continue operations in Puerto Rico.[97]

6, 1954 P.R. Laws 12 (codified as amended at P.R. LAWS ANN. tit. 13, §§ 241-251 (1978)) and again by the Puerto Rico Industrial Incentive Act of 1963, No. 57, 1963 P.R. Laws 120 (codified as amended at P.R. LAWS ANN. tit. 13, §§ 252-252j (1978)). The law currently effective in Puerto Rico is the Industrial Incentives Act of 1978, No. 26, 1978 P.R. Laws 55 (codified as amended at P.R. LAWS ANN. tit. 13, §§ 255-255n (Supp. 1986)). This law will remain in effect until June 30, 1988. *Id.* § 255m.

[92] "Operation Bootstrap" was conceived by Puerto Rican Governor Luis Muñoz Marín. The program promised United States corporations "cheap labor, exemptions from island taxes for up to 25 years (along with total exemption from Federal corporate and private income taxes), and assistance in the building of plants." Tansill, *supra* note 22, at 93; *see also* 128 CONG. REC. S8800 (1982) (statement of Sen. Johnston). For a history of Puerto Rico since Operation Bootstrap, see Martin, *supra* note 56, at 7.

[93] In essence, section 936 companies elect to receive the tax benefits of § 936 while voluntarily renouncing other relatively minor benefits under the Internal Revenue Code. *See* Costas Elena, pt. 1, *supra* note 89, at 583 & n.137.

[94] *See Comprehensive Tax Reform, Part 6, supra* note 9, at 5007; Comment, *supra* note 89, at 538 (stating that most section 936 companies between 1947 and 1972 were "petroleum refining, petrochemicals, plastics, textiles, and apparel" enterprises).

[95] Real GNP in Puerto Rico grew by average yearly rates of 5.3% and 7.0% in the 1950s and 1960s respectively, compared to average real GNP growth in the United States of 3.7% for the 20 year period. Martin, *supra* note 56, at 7; Rivera, *Beyond Section 936: A Suggested Departure from Tax-Sheltered Stagnation in Puerto Rico,* 47 REV. COL. AB. P.R. 143, 146 (1986). Puerto Rico also made great strides in "education, health, housing, public works, and other areas." *Id.*

[96] Boletin Economico, *La Seccion 936 Del Codigo de Rentas Internas Federal y su Impacto en la Economia de Puerto Rico (Primera Parte)* 47 (Oct. 1980) (stating that approximately $3 billion of § 936 funds had been invested outside Puerto Rico, primarily in the Eurodollar market); Comment, *supra* note 89, at 535-36. Under tax provisions that were effective during the early 1970s, this income was exempt from both Puerto Rican and United States tax. *Id.*

[97] *See* Comment, *supra* note 89, at 536.

In response to these problems, Congress passed section 936 in the Tax Act of 1976.[98] By giving preferential treatment only to "qualified possession source investment income" (QPSII), this provision increased the likelihood that United States corporations would invest their income in Puerto Rican banks.[99] QPSII is defined as passive investment income derived from the active conduct of a trade or business that is located in the possession.[100] Under the 1976 Act, income derived from QPSII could equal up to fifty percent of the total income of the section 936 company.[101] QPSII could be deposited in Puerto Rican banks, where, if it met the requirements for QPSII in both section 936 and Puerto Rican tax law, this income would draw tax-free interest.[102] The banks could then use these funds to finance development in the Commonwealth.[103] The 1976 Act also changed the form of the Puerto Rican

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[98] Tax Reform Act of 1976, Pub. L. No. 94-455, § 1051, 90 Stat. 1520, 1643-47 (codified as amended at 26 U.S.C. § 936 (1982)). Under § 936, a tax credit is awarded to United States corporations, if, for a three-year period, at least 80% of the gross income of the corporation is derived from sources within Puerto Rico, and at least 50% of the gross income is derived from the active conduct of a trade or business in Puerto Rico. 26 U.S.C. § 936(a)(2) (1982). For a general discussion of § 936 after the Tax Reform Act of 1976, see Costas Elena, pt. 1, *supra* note 89, at 574-84.

[99] 26 U.S.C. § 936(a)(1), (d)(2) (1982). Under § 936, possessions corporations could no longer receive tax-free interest on income invested outside of Puerto Rico. *See Tax Reform Act of 1986, Part III, Hearing Before the Senate Comm. on Finance*, 99th Cong., 2d Sess. 1301 (1986) [hereinafter *Tax Reform Act of 1986, Part III*] (stating that the 1976 amendments to § 936 resulted in an influx of § 936 funds into Puerto Rico which had been invested abroad in the Eurodollar market).

[100] 26 U.S.C. § 936(d)(2) (1982); *see* Costas Elena, pt. 2, *supra* note 89, at 106 ("Qualified possession source investment income thus has 1) a possession source, 2) a possession use, 3) an established connection between such source and use within the same possession, and 4) a federal supervisor.").

[101] 26 U.S.C. § 936(a)(1) (1982). A section 936 company is a subsidiary of a United States corporation set up in Puerto Rico designed to take advantage of the section 936 tax advantages.

[102] Interest on funds derived from QPSII remains tax-exempt only as long as the funds are reinvested in eligible activities in Puerto Rico. 26 U.S.C.A. § 936(d)(4)(A) (West 1987); *see* Rublin, *Comeback in the Caribbean: Puerto Rico's Back in Business*, Barrons, Feb. 10, 1986, at 6, *reprinted in* 132 CONG. REC. E658 (daily ed. Mar. 6, 1986); *see also Puerto Rico and the Section 936 Tax Incentives: Hearing Before the Subcomm. on General Oversight and Renegotiation of the House Comm. on Banking, Finance and Urban Affairs*, 97th Cong., 2d Sess. 66-68 (1982) (statement of Carmen A. Culpeper, Sec'y of the Treas. of Puerto Rico) [hereinafter Culpeper] (discussing the investment of QPSII in eligible local activities). For a list of eligible activities, see Boletin Economico, *supra* note 96, at 48-50. However, income from tax-exempt investments (such as municipal bonds) does not come into the calculation for QPSII and therefore remains tax exempt even though not invested in eligible activities. *See* Costas Elena, pt. 1, *supra* note 89, at 576-77 (discussing Puerto Rican companies investing in Guam bonds).

[103] *See* Boletin Economico, *supra* note 96, at 48 (discussing Puerto Rican incentives for section 936 corporations to reinvest their profits in the island). *But see* Costas Elena, pt. 1, *supra* note 89, at 571 (stating that § 936 has not been effective in lowering interest rates in Puerto Rico and that § 936 funds have not been accessible to the

tax break from a tax exemption to a tax credit,[104] and permitted a full dividends-received deduction on possessions income repatriated to a United States parent company.[105]

During the 1970s, a change took place in the composition of United States corporations investing in Puerto Rico. As a result of increasing costs of production in Puerto Rico, the composition shifted from labor-intensive manufacturing operations to capital-intensive, high-tech industries, particularly pharmaceuticals and electronics.[106] This shift resulted in increased demand for skilled labor in Puerto Rico and decreased demand for low-wage, unskilled labor.[107]

In the early 1980s, partly as a result of the increase in high-tech industries' attraction to Puerto Rico, many members of Congress advocated drastic changes in section 936.[108] High-tech industries are research oriented, with competitive advantages going to corporations which develop new medical and scientific breakthroughs. During this period, United States pharmaceutical corporations were conducting research in the United States, receiving a tax deduction for research and development expenses incurred,[109] and then sending the patented

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average Puerto Rican borrower). The duration of § 936 deposits is generally short; approximately 70% bear maturities of 90 days or less. *See Tax Reform Act of 1986, Part III, supra* note 99, at 1303. This short-term approach to § 936 deposits is a result primarily of the uncertainty surrounding § 936 and the depositors' reluctance to commit long-term funds to an uncertain provision. *See* Culpeper, *supra* note 102, at 65-66.

[104] 26 U.S.C. § 936(a)(1) (1982); *see* Costas Elena, pt. 1, *supra* note 89, at 574 (stating that although the law changed § 936 from a tax exemption to a tax credit, the result was the same). In essence, this tax credit allows a section 936 corporation "a *federal income tax credit for taxes* which it has *never paid.*" *Id.* at 585 (emphasis in original).

[105] 26 U.S.C. § 243(b) (1982).

[106] *See* Comment, *supra* note 89, at 539 (stating that the shift in composition was due partially to changes in world economic conditions and partially to increased costs of production in Puerto Rico). This shift from labor-intensive to capital-intensive industry resulted partly from the imposition of minimum wage laws on Puerto Rico, and partly from the increased skill and education levels of Puerto Rican workers. *See Comprehensive Tax Reform, Part 9 of 9, Hearings Before the House Comm. on Ways and Means*, 99th Cong., 1st Sess. 9103 (1985) [hereinafter *Comprehensive Tax Reform, Part 9*]; 131 CONG. REC. S2536 (daily ed. Mar. 5, 1985) (speech by Sen. Wallop). It is interesting to note that American Samoa, another United States possession protected by § 936, did not experience a shift away from labor-intensive industry and still operates as § 936 was designed. *See Comprehensive Tax Reform, Part 6, supra* note 9, at 4915.

[107] *See* Comment, *supra* note 89, at 538-39. The decrease in demand for low-wage, unskilled labor is also partly attributable to the impact of federal statutes and programs in Puerto Rico, including minimum wage laws, unemployment compensation, and food stamps. *Id.*

[108] 128 CONG. REC. 17,233-37 (1982) (statement of Sen. Dole) [hereinafter Statement of Sen. Dole]; *see also* REPORT OF THE SENATE COMM. ON FINANCE ON H. R. 4961, S. REP. No. 494, 97th Cong., 2d Sess., Vol. 1, 155 (1982).

[109] 26 U.S.C. § 174 (1982); *see also* 26 U.S.C. § 44F (1982) (allowing a research

processes to their Puerto Rican subsidiaries and receiving a tax credit for all profits derived from the United States-developed processes.[110] This practice, which was common among pharmaceutical corporations,[111] took advantage of a major loophole in section 936.[112]

Instead of repealing section 936, Congress amended it in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[113] The amendments to section 936 under TEFRA were designed to make it much more difficult for United States corporations to transfer patented processes to Puerto Rican subsidiaries tax free.[114] In addition, the amount of QPSII allowed tax-free treatment was reduced from fifty percent to thirty-five percent.[115] Congress also promised Puerto Rico that no additional changes would be made in the possessions tax credit until TEFRA was given a chance to take effect.[116]

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and development credit in certain instances).

[110] *See* Statement of Sen. Dole, *supra* note 108, at 17,235; Comment, *supra* note 89, at 541; Turner, *Is It Time to End Puerto Rican Tax Haven?*, J. Com., July 11, 1985, at 15A, col. 1; Highley, *Sec. 936 Still Spurs Industry*, J. Com., June 7, 1983, at 13, col. 1.

[111] Statement of Sen. Dole, *supra* note 108, at 17,235-35 (stating that two drug companies had even brought the matter to court); Comment, *supra* note 89, at 541. In Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), the United States parent company was transferring manufacturing patents to its Puerto Rican subsidiary. The Tax Court required that the transaction be at arms length rather than at lower pricing levels charged within the corporate entity. *See also* G.D. Searle & Co., 88 T.C. 252 (1987) (parent corporation transferred both manufacturing and marketing intangibles to its Puerto Rican subsidiary).

[112] Senator Robert Dole stated, "A clearer case of having your cake and eating it, too, has seldom existed in the U.S. tax law." Statement of Sen. Dole, *supra* note 108, at 17,235. For some of these companies, the revenue loss to the United States was over $100,000 per Puerto Rican job created. *Id.*

[113] Tax Equity and Fiscal Responsibility Act of 1982 [hereinafter TEFRA], Pub. L. No. 97-248, § 213, 96 Stat. 324, 452-66 (codified at 26 U.S.C. § 936 (1982)). The provisions of TEFRA relating to § 936 were a joint effort by Puerto Rican leaders and United States Treasury officials.

[114] 26 U.S.C. § 936(h) (1982) (tax treatment of intangible income). Subsection 936(h) gives section 936 companies two methods by which possessions corporations could elect out of being taxed on transfers of intangible property to Puerto Rican subsidiaries: (1) the cost-sharing method, which allows a possessions corporation to treat intangible income as received in Puerto Rico if it makes a payment to its United States affiliate for its share of research and development expenses, and (2) the profit split method, which requires that taxable income from intangible property be apportioned among affiliates on a product-by-product basis. For a detailed discussion of TEFRA and § 936, see Comment, *supra* note 89, at 543-58. For examples of how the § 936 TEFRA Amendments work, see *Nordberg on the Proposed Section 936(h) Regulations*, 17 TAX NOTES, Nov. 22, 1982, at 625.

[115] 26 U.S.C. § 936(a)(2)(B) (1982). TEFRA phased in the reduction in QPSII by increasing the amount attributable to the active conduct of trade or business to 55% in 1983 and to 60% in 1984. 26 U.S.C. § 936 (a)(2)(C) (1982).

[116] This promise was deemed a "moral commitment" by Governor Hernández Colón of Puerto Rico. Turner, *supra* note 110; *see also Comprehensive Tax Reform, Part 6*, *supra* note 9, at 4983 (letter from Hon. William M. Gray, III to Hon. Jaime

3.2. The Tax Reform Act of 1986

3.2.1. The Treasury Department's Wage Credit Proposal

In November 1984, the Treasury Department presented its recommendations for a total restructuring of the Internal Revenue Code.[117] Among its recommendations, the report urged that section 936 be repealed and replaced with a wage credit.[118] The Treasury Department's rationale was that the possessions tax credit was costing the government too much in lost revenue while possessions corporations were gaining a windfall: the federal government lost $22,000 per Puerto Rican employee, while the average wage of each employee was only $14,210.[119] Furthermore, section 936 was susceptible to abuse,[120] was extremely complex and difficult to administer,[121] and was not effective in increasing employment in Puerto Rico.[122] This recommendation was accepted

Fuster).

[117] Treasury Department, *supra* note 14.

[118] *Id.* at 328.

[119] *Id.* at 328; Turner, *supra* note 110; *see also* Sheppard, *supra* note 14, at 1075. "I.R.C. section 936 is among the ten highest corporate tax expenditures in the Internal Revenue Code." Costas Elena, pt. 1, *supra* note 89, at 564. Costas Elena further states that "[b]y 1983 I.R.C. section 936 will cost the United States in income taxes lost every year an estimated $1,076,000,000 . . . . [The system of § 936 and Puerto Rican tax exemptions] fails to confront directly, much less resolve, the problem of chronically high unemployment in Puerto Rico." *Id.* (footnotes omitted). *But see* Timberlake, *supra* note 14, at 1185 (quoting Ass't Treas. Sec'y Pearlman as stating that a wage credit "may not be the answer").

[120] Treasury Department, *supra* note 14, at 328. For a discussion of pre-1982 abuse, see Statement of Sen. Dole, *supra* note 108, at 17,235; *see also* Costas Elena, pt. 1, *supra* note 89, at 565 (discussing profit-shifting through the dividends-received deduction of 26 U.S.C. § 243 (1982)). At the time of the proposed repeal of § 936 in 1984, many § 936 companies were continuing to abuse their credits. *See Comprehensive Tax Reform, Part 6*, *supra* note 9, at 5005. Costas Elena also asserts that § 936 is subject to abuse not only by United States corporations, but also by government agencies administering the exemptions. Costas Elena, pt. 1, *supra* note 89, at 567 ("The Economic Development Administration of Puerto Rico cannot and will not impartially regulate the possessions corporations.").

[121] Treasury Department, *supra* note 14, at 328; *see* Costas Elena, pt. 1, *supra* note 89, at 566 ("Neither the United States nor Puerto Rico has gathered systematic and authoritative information on the financial legerdemains of the possession corporations." As much as $500 million of section 936 companies' exempt profits remain "unaccounted for" by tax authorities.). *But see* Ture, *Treasury Prepares a Caribbean Austerity Initiative*, *reprinted in* 131 CONG. REC. E1486 (daily ed. Apr. 16, 1985) (stating that the complexity of § 936 is largely the Treasury Department's fault, and outright repeal is not the way to simplify its complex application).

[122] Treasury Department, *supra* note 14, at 328. The main purpose of § 936 has been to encourage job creation in Puerto Rico by United States investors. Sheppard, *supra* note 14, at 1075. Under present law, however, the mechanics of § 936(h) allow most section 936 corporations to obtain the tax benefit by making only minimal efforts. *Id.*; *see* Costas Elena, pt. 1, *supra* note 89, at 563; *see also id.* at 564 (stating that under § 936 (citing Puerto Rican government studies) unemployment in Puerto Rico has always been above 10%, and was 16.5% in April 1978, "higher than the 15%

by the President and sent to Congress in May 1985.[123]

While congressional committees discussed provisions of the new tax law, various groups lobbied intensively for the retention of section 936. This lobbying was done particularly by the Government of Puerto Rico[124] and by United States companies conducting business in and currently located in Puerto Rico.[125] Puerto Rican lobbyists vigorously opposed the wage credit, arguing that it would not be as effective as the Possessions Tax Credit in attracting United States investment.[126] Supporters of section 936 also denounced the wage credit because Puerto Rico was competing for jobs not against the states, but against foreign countries. Producers in these foreign countries enjoyed comparatively low production costs because, unlike their Puerto Rican counterparts, they were not subject to United States minimum wage laws, union de-

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unemployment of 1940"); *id.* at 569 (stating that section 936 corporations never provided the employment that they promised in their petitions for Puerto Rican tax exemption). *But see Comprehensive Tax Reform, Part 6, supra* note 9, at 5001 (describing Puerto Rico's pre-section 936 unemployment rate of 47.5%).

[123] President's Tax Proposals, *supra* note 14, at 307.

[124] *See Comprehensive Tax Reform, Part 6, supra* note 9, at 4975 (statement of Hon. Jaime B. Fuster, Resident Comm'r of Puerto Rico); *id.* at 4987 (statement of Hon. Rafael Hernández Colón, Governor of Puerto Rico); *id.* at 4990 (statement of Antonio J. Colorado, Administrator, Economic Development Administration, Puerto Rico); *see also Governor Lobbies Against Repeal, supra* note 14; Sheppard, *supra* note 14, at 1074 (noting Gov. Hernández Colón's statement, which was made while lobbying Treas. Sec'y Baker, that the repeal of § 936 would lead to a mass exodus of United States corporations from the island, an increase in the already high unemployment rate and political instability). Other leaders of United States possessions also lobbied for the retention of § 936. *See Comprehensive Tax Reform, Part 6, supra* note 9, at 4913 (American Samoa); *id.* at 4928 (United States Virgin Islands).

[125] At the time of the proposed repeal, 24% of Puerto Rican jobs were directly or indirectly attributable to section 936 companies. *Comprehensive Tax Reform, Part 6, supra* note 9, at 5025. United States groups lobbying to retain § 936 included the Puerto Rican Manufacturers Association, *id.* at 5014; the Puerto Rico-U.S.A. Foundation, representing 29 section 936 companies, *id.* at 5093; the Pharmaceutical Manufacturers Association, *id.* at 5107; the Generic Pharmaceutical Industry Association, *id.* at 5157; Starkist Foods, Inc. in American Samoa, *id.* at 4920; and Ralston Purina Co., *Comprehensive Tax Reform, Part 9, supra* note 106, at 9107. In addition to lobbying, section 936 companies also put pressure on the Puerto Rican government by taking a wait-and-see attitude toward continued investment and by threatening to exit Puerto Rico if Congress repealed § 936. *See* Highley, *Survey: Most U.S. Firms Would Exit*, J. Com., Mar. 25, 1985, at 3A, col. 4; O'Reilly, *Puerto Rico Defends Tax Exemption*, J. Com., Mar. 25, 1985, at 3A, col. 3.

[126] *See Comprehensive Tax Reform, Part 6, supra* note 9, at 4988 (assertion by Gov. Hernández Colón that a wage credit would drive away capital-intensive industry); *Governor Lobbies Against Repeal, supra* note 14 (quoting Gov. Carlos Romero-Barcelo of Puerto Rico to the effect that the wage credit would not work because "it will be phased out before new companies can set up"); *The Impact of a Wage Credit in Puerto Rico*, 27 TAX NOTES, May 20, 1985, at 942. *See generally* C. BONILLA, A NEW, BUT NOT IMPROVED, WAGE CREDIT TO REPLACE SECTION 936 (Institute for Research on the Economics of Taxation Rep. No. 32) (1985) (providing an in-depth analysis of the wage credit and reasons why it should not replace § 936).

mands, and United States shipping specifications (which require shipment of goods in United States merchant ships, the most expensive in the world).[127] Finally, lobbyists maintained that repeal of section 936 would not increase tax revenue to the United States because possessions corporations would simply reincorporate in low-tax foreign countries and be able to defer taxation indefinitely.[128]

3.2.2. *Governor Hernández Colón's Twin Plant Proposal*

In his inaugural address in early 1985, Governor Raphael Hernández Colón of Puerto Rico proposed what became known as the "Twin Plant Program."[129] Under this proposal, Governor Hernández Colón offered $700 million of section 936 funds for industrial development in qualified CBI countries.[130]

The basic plan of the Twin Plant Program would enable United States corporations to set up two plants: one in Puerto Rico, and one in a qualified CBI beneficiary country. The plant in the CBI country would produce the more labor-intensive aspects of the manufacturing process, and then ship the unfinished product to Puerto Rico, where the skilled work and capital-intensive processes would be added to the product.[131] According to this scheme, the United States corporation

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[127] *Comprehensive Tax Reform, Part 6, supra* note 9, at 4999, 5017; *Comprehensive Tax Reform, Part 9, supra* note 106, at 9102-03; *Tax Reform Act of 1986, Part III, supra* note 99, at 1318; *see also* Sheppard, *supra* note 14, at 1074 (quoting an attorney representing Puerto Rico to the effect that the wage credit was not enough to combat high costs associated with United States minimum wage laws and environmental restrictions). For a good discussion of how minimum wage laws were imposed in Puerto Rico, see Costas Elena, pt. 1, *supra* note 89, at 588-96. The average wage of a comparable employee in Puerto Rico, however, is still much lower than the minimum wage applicable to the mainland United States, even though the cost of living in Puerto Rico is higher than that on the mainland. *See id.* at 595. Although it is often claimed that the expense of shipping on United States carriers increases the costs of production in Puerto Rico, the cost of shipping from the island has been historically low. *Id.* at 596-601. Likewise, the argument of high shipping costs fails to take into account that, in most situations, shipping costs are either born by the section 936 parent company (on the United States mainland) or passed on to the ultimate consumer. *Id.* at 599.

[128] *See* Sheppard, *supra* note 14, at 1074.

[129] Rivas, *Hernández Colón Pulls CBI Surprise*, CARIBBEAN BUS., Jan. 9, 1985, at 1; *see Comprehensive Tax Reform, Part 6, supra* note 9, at 4989 (statement of Gov. Hernández Colón).

[130] Statement by Governor Hernández Colón to the Conference on Democracy for the English-Speaking Caribbean, in Bridgetown, Barbados (Nov. 9, 1985), *reprinted in* 131 CONG. REC. E5410 (daily ed. Dec. 4, 1985); O'Reilly, *supra* note 2, at 1A, col. 2; Rivas, *supra* note 129, at 1. This "twin plant" idea was not new: the American Chamber of Commerce had proposed the idea in the Dominican Republic as early as 1982. Russin & Rubin, *Using Possessions Corporation Funds in the Caribbean Basin: A Proposal*, 8 INT'L TAX J. 352 (1982).

[131] Economic Development Administration of Puerto Rico, Puerto Rico and the Caribbean Basin Initiative 4 (Memorandum of May 10, 1985) (available from the

would receive three benefits: use of low-cost labor in the Caribbean Basin nation, duty-free importation of the unfinished product from the CBI country into Puerto Rico, and retention of a Puerto Rican tax credit. At the time of Governor Hernández Colón's proposal, twenty-four United States corporations were already operating twin plants in the Caribbean,[132] and twenty-four additional corporations had pledged to invest in twin plants if the section 936 funds became available under the Tax Reform Act of 1986.[133]

Puerto Rico enthusiastically implemented the program and provided funds for twin plant investments as early as May 1985.[134] While implementation was going forward in Puerto Rico, Governor Hernández Colón, Antonio Colorado (then president of the Puerto Rican Economic Development Administration), and other Puerto Rican officials lobbied Congress and Treasury Secretary James A. Baker to include a similar provision in the Tax Reform Act of 1986.[135] President Reagan supported the Twin Plant Program in a February 1986 speech delivered in Grenada.[136] Thereafter, Congress agreed to retain section 936 in the 1986 Act if Governor Hernández Colón would agree to free up $100 million of restricted section 936 funds annually for investment in CBI countries.[137]

Puerto Rican Economic Development Administration) [hereinafter Puerto Rico and the CBI]; *see also* O'Reilly, *supra* note 2, at 1A, col. 3; Wylie, *supra* note 12, at 6.

[132] *Twin Plants in Operation Now*, BUS. AM., Nov. 25, 1985, at 10.

[133] Dunlap, *Puerto Rico Seeks Twin-Plant Investors*, J. Com., Nov. 27, 1985, at 3A, col. 1; *see also Comprehensive Tax Reform, Part 6, supra* note 9, at 5044.

[134] *First "CBI" Loan Granted by GDB*, 10 P.R. BUS. REV., May-June 1985, at 1.

[135] O'Reilly, *supra* note 2, at 1A. The Treasury Department was at first skeptical of the Twin Plant Program because commitments made by section 936 companies were not binding, and there was no way to gauge how much investment the plan would generate. The Department also wanted to see the United States take a more active role in implementing the Twin Plant Program perhaps to the point of taking away the tax benefits of section 936 from companies that refused to participate in the program. Therefore, Puerto Rico and the Treasury Department were prepared to enter into an Executive Agreement to insure that the commitments of section 936 companies would be preserved. 131 CONG. REC. E5410 (daily ed. Dec. 4, 1985) (statement of Gov. Hernández Colón); *see also* Memorandum of Agreement between the Government of the United States and the Government of Puerto Rico, Nov. 14, 1985, *cited in* THE TAX REFORM ACT OF 1986, H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-632 (1986) [hereinafter Memorandum of Agreement].

[136] Speech by President Reagan to the citizens of Grenada (Feb. 20, 1986), *cited in* 131 CONG. REC. E516 (daily ed. Feb. 27, 1986) [hereinafter President Reagan's Grenada speech].

[137] Memorandum of Agreement, *supra* note 135, at II-632; *Tax Reform Act of 1986, Part III, supra* note 99, at 1323; *Tax Breaks, supra* note 12. For information concerning interest rates, lending limits, and repayment terms on CBI loans for twin plants, see *Government Development Bank Loan Policies for Complementary Projects Under the Caribbean Basin Initiative (CBI)*, 10 P.R. BUS. REV., Aug.-Sept. 1985, at 8 [hereinafter *Government Development Bank Loan Policies*]; Mudie, *GDB-CBI Incen-*

3.2.3. Provisions of Section 936 Under the Tax Reform Act of 1986

In addition to the modifications to section 936 to allow funding for CBI development projects, the Tax Reform Act of 1986 made other adjustments to past provisions. The percentage of income a possessions corporation could attribute to QPSII was again reduced, from thirty-five percent to twenty-five percent.[138] Furthermore, Congress amended section 936 provisions dealing with transfers of intangibles to Puerto Rico and the treatment of royalty payments by a possessions corporation.[139] Finally, the definition of "possession" was expanded to include the United States Virgin Islands.[140]

Under the CBI investment provisions of amended section 936, Congress will allow section 936 corporations to receive a tax credit for QPSII invested in a qualified Caribbean Basin country as long as (1) the investment is used to purchase active business assets or (2) the investment is in development projects in the qualified country.[141] A qualified Caribbean Basin country is defined as any country which meets the requirements of a beneficiary country under the Caribbean Basin Economic Recovery Act, including the requirements for holding tax-exempt conventions.[142]

The Government Development Bank must specifically authorize the use of section 936 funds for CBI investment in accordance with regulations issued by the Puerto Rican Secretary of the Treasury.[143] Furthermore, the borrower of section 936 funds must certify to the Puerto Rican Secretary of the Treasury that the funds will be used

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tive Loan Program, BUS. AM., Nov. 25, 1985, at 6. The bulk of the investment, however, is still expected to come from private companies participating in the Twin Plant Program rather than from Puerto Rican government loans. *Tax Breaks*, *supra* note 12.

[138] 26 U.S.C.A. § 936(a)(2)(B) (West 1987); *see also Tax Reform Act of 1986, Part III*, *supra* note 99, at 1304 (testimony of Alberto M. Paracchini, President of the Puerto Rico Bankers Association) (opposing the reduction of QPSII from 35% to 25%). For a discussion of previous reduction, see *supra* note 115 and accompanying text.

[139] 26 U.S.C.A. §§ 367(d)(2), 482, 936(h) (West 1987). For an analysis of intangible transfers to possessions corporations after the Tax Reform Act of 1986, see Aud, Gordon, & Benson, *Determining the Taxable Income of Possessions Corporations Under Final § 936(h) Regulations*, 15 TAX MGMT. INT'L J. 315 (1986).

[140] 26 U.S.C.A. § 936 (d)(1) (West 1987). Taxation of United States Virgin Islands source income had previously come under § 934A, which was repealed by the 1986 Act. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1275(c)(3), 100 Stat. 2085, 2599.

[141] 26 U.S.C.A. § 936(d)(4)(A)(i) (West 1987).

[142] 26 U.S.C.A. § 936(d)(4)(B) (West 1987). These requirements include filing exchange-of-information agreements with the United States Treasury, and having no discriminatory tax laws against conventions held in the United States. *See* 19 U.S.C. § 2702(a)(1)(A) (Supp. 1985); 26 U.S.C.A. § 274(h)(6) (West 1987).

[143] 26 U.S.C.A. § 936(d)(4)(A)(i) (West 1987).

promptly within the restrictions of the Act.[144] In addition, the borrower must agree to let the Secretary of the Treasury examine its books to ensure that the borrower is complying with all relevant requirements.[145]

4. Impact of Amended Section 936 and the Twin Plant Program on CBI Nations

The Tax Reform Act of 1986 and Puerto Rico's Twin Plant Program have been lauded by both United States and Caribbean leaders as furthering the objectives of the CBI and as likely to provide the countries of the Caribbean Basin with substantial investment opportunities.[146] Many analysts believe that amended section 936 will bolster the faltering CBI.[147]

4.1. Current Problems of CBI Nations

Despite the intention of the CBI to address regional economic problems, complex obstacles to economic development remain; United States investment initiatives and the Twin Plant Program will not be a panacea for the region's deep-seated problems.[148] Factors such as political instability and overinvolvement of the public sector in Caribbean development,[149] lack of infrastructure in poorer beneficiary nations,[150] and United States protectionism[151] could prevent CBI nations from gaining any lasting benefits from funds invested under section 936. It is necessary to analyze some of the chronic problems of Caribbean Basin nations in order to determine the potential impact of these investment programs.

4.1.1. The Overinvolvement of Government in the Private Sector

Two problems may develop when the public sector becomes too

[144] *Id.* § 936(d)(4)(C)(i).
[145] *Id.* § 936(d)(4)(C)(ii).
[146] *Review of the CBI*, *supra* note 2, at 8 (statement of Hon. Clayton Yeutter, United States Trade Representative); Seaga, *A Close Look at CBI and Puerto Rico*, 11 P.R. Bus. Rev., Jan. 1986, at 13 (Edward Seaga is President of Jamaica.).
[147] *Review of the CBI*, *supra* note 2, at 329 (statement of Dr. Joseph E. Edmunds, Ambassador of St. Lucia to the United States); *CBI and U.S. Minority Participation*, *supra* note 76, at 2, 86.
[148] Even before passage of the CBI, many critics in the United States and the Caribbean felt that it was unlikely that the program would have any major impact on the "deep-rooted problems" of the Caribbean. A. Payne, *supra* note 2, at 62.
[149] *See infra* Section 4.1.1.
[150] *See infra* Section 4.1.2.
[151] *See infra* Section 4.1.3; *see also* Cullen, *supra* note 2, at 44.

involved in the private sector. First, excess governmental involvement in the private sector increases the financial burden on the already under-financed government and makes it more likely that the small country will have difficulty paying its international debts.[152] Second, a small, developing nation which aggressively involves itself in the private sector may send out signals to foreign investors that investments placed in that nation would be made at the risk of being subject to excess regulation[153] and control,[154] or possibly nationalization.[155]

In the weak economies of Caribbean Basin countries, economic problems often lead to political instability.[156] Once the government steps in to help the private sector in an economic crisis, foreign investors perceive the government's intervention as a threat to their investment interests.[157] The cycle continues when foreign investors withdraw their capital from the politically unstable economy; this withdrawal of capital exacerbates the economic and political problems of the nation.[158]

The Twin Plant Program will, unfortunately, have only a limited effect on promoting political stability in the Caribbean Basin. The pro-

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[152] Pastor, *supra* note 2, at 1049. At the time of the passage of the CBI, many Caribbean leaders criticized the program's emphasis on investment and trade rather than on direct developmental aid. *See* A. PAYNE, *supra* note 2, at 144-45 ("[T]here is no disagreement with Washington's dictum that the region's poor countries must pull themselves up by their own bootstraps. But first we must have the straps with which to pull up the boots.") (quoting Vere Bird, Prime Minister of Antigua & Barbuda).

[153] Excess regulation and governmental red tape in Caribbean nations not only discourage foreign investors from investing in the nation, they also stifle domestic industry and entrepreneurial creativity. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 24; *see also* President Reagan's Grenada speech, *supra* note 136.

[154] Jamaica's policy of "ownership and control" of business in the 1970s not only prevented foreign merchants from investing in the country, but also drove out Jamaican capital. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 17. *See generally* Ambursley, *Jamaica: From Michael Manley to Edward Seaga*, in CRISIS IN THE CARIBBEAN 72 (F. Ambursley & R. Cohen eds. 1983) (discussing Manley's socialism and Seaga's return to a capitalist model).

The risk of takeover or military coup in a Caribbean Basin nation further discourages private industry from investing capital which it might never recover.

[155] Guyana's nationalization of the private sector motivated foreign investors to leave, thereby exacerbating the country's economic problems. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 17. *See generally* Thomas, *State Capitalism in Guyana: An Assessment of Burnham's Co-operative Socialist Republic*, in CRISIS IN THE CARIBBEAN, *supra* note 154, at 27 (discussing Guyana's economic problems within its state property model).

[156] *See supra* notes 54 & 57 and accompanying text; 131 CONG. REC. E2168 (daily ed. May 14, 1985) ("[T]he absence of economic growth, be it in Puerto Rico or elsewhere in the Caribbean Basin, will increase the vulnerability to social and political instability.") (statement of Hon. Jaime B. Fuster).

[157] ENGLISH-SPEAKING CARIBBEAN, supra note 2, at 16-17; *Dilemmas of Caribbean Development*, *supra* note 40, at 262 (stating that many foreign investors depend on local Caribbean governments to guarantee the security of their investments).

[158] *See supra* notes 54, 57, & 156 and accompanying text.

gram, providing only economic support, does not address the fundamental problem of United States investors' reluctance to invest in politically unstable Caribbean nations, and in fact can do little to encourage investment in any particular country.[159] While the Twin Plant Program can help to prevent economic problems from developing into political problems, it can do little to encourage investment in countries where political problems already exist. In most cases, therefore, the very nations which need the most help from the private sector to overcome political instability and unrest will receive little, if any, private sector investment.[160] United States investors will simply continue to choose the most stable CBI nations in which to concentrate their investments.[161]

4.1.2. Lack of Infrastructure

Many of the poorer CBI nations lack the basic infrastructure necessary to support the most basic industrial processes. For example, Dominica, a small, independent island in the Eastern Caribbean, does not have an airport capable of handling jet aircraft; and, although water is an abundant resource, Dominica lacks the capacity to properly harness the water for industrial use.[162] Antigua & Barbuda, another Eastern Caribbean nation, experiences frequent energy shutdowns and water shortages, a condition which prevents expansion of its tourism industry and constrains manufacturing operations.[163]

Infrastructure problems such as these usually cannot be solved by private investment; these nations need direct economic aid in order to develop the basic infrastructure necessary to attract foreign investment.[164] Direct aid, however, often goes toward improving the most immediate problems first, such as making interest payments on international debt,[165] and only the small amount remaining is spent on actual

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[159] The uneven distribution of present twin plants demonstrates Puerto Rico's lack of control over the allocation of its § 936 funds. Of the 25 twin plant projects in operation as of July 1986, 16 are located in the Dominican Republic, 5 in Haiti, 2 in Barbados, 1 in St. Kitts, and 1 in Grenada. *Puerto Rico Companies with Complementary Projects in the Caribbean*, 11 P.R. BUS. REV., July 1986, at 4-5.

[160] *See* Pastor, *supra* note 2, at 1044 ("[T]he most significant trade and investment provisions will have the least impact on those countries with the most urgent need for political stability.").

[161] *See* Pastor, *supra* note 2, at 1044 (stating that the CBI's impact will be limited to politically stable areas).

[162] EASTERN CARIBBEAN REPORT, *supra* note 40, at 13.

[163] *Id.*

[164] *Id.* at 21.

[165] Countries with adequate infrastructures are unable to maintain them when faced with seemingly insurmountable international debt payments. In Jamaica, for example, the debt problem led to infrastructure problems such as roads not being repaired

development.[166] Often the smaller, lesser developed nations, which need the most help, receive the smallest proportion of economic aid.[167] The infrastructure problem thus becomes self-perpetuating: lack of infrastructure discourages foreign corporations from investing in the country, and the resulting lack of investment prevents the country from developing its infrastructure.[168]

The United States Government has recognized the infrastructure problems in small Caribbean Basin nations and has developed several programs to assist their economic progress.[169] The Twin Plant Program seeks to expand on these development efforts by giving preferences to projects which most directly support economic growth in CBI nations.[170] Although it is too early to tell whether Puerto Rico can have a substantial impact on funding infrastructure projects, the Twin Plant Program is a step in the right direction.

4.1.3. United States Protectionism of its Domestic Industry

Protectionism represents a dangerous threat to the success of the Twin Plant Program and other investment incentives; in response to protectionist pressure, the United States often gives benefits to CBI nations with one hand and takes them away with the other. The CBI

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and hospitals not being able to purchase necessary medical supplies. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 23.

[166] *See* Cullen, *supra* note 2, at 44 (noting that, for example, some of the Dominican Republic's aid goes to Dominican street vendors to enable them to purchase their own bicycles).

[167] *See* A. PAYNE, *supra* note 2, at 62-63. Moreover, smaller countries must invest a higher per capita amount on basic infrastructure needs to achieve the same results as the larger nations. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 31 (statement of Georges Fauriol).

[168] *See* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 55 ("[T]he constraint to any kind of development is infrastructure."); A. PAYNE, *supra* note 2, at 63 (stating that lack of infrastructure will aggravate rather than lessen disparities between Caribbean nations).

[169] 131 CONG. REC. E378-79 (daily ed. Feb. 6, 1985) (statement of Hon. Dymally) (proposing the use of the Peace Corps to assist Caribbean nations in infrastructure development projects such as water management, electrification, and road maintenance); *CBI and U.S. Minority Participation*, *supra* note 76, at 39 (discussing efforts to improve the infrastructures of Caribbean Basin countries through United States governmental programs); EASTERN CARIBBEAN REPORT, *supra* note 40, at 21 (discussing the use of the Peace Corps, AID and other government development organizations in the Eastern Caribbean).

[170] *See* DELEGATION MISSION REPORT, *supra* note 12, at 5; *Government Development Bank Loan Policies*, *supra* note 137, at 8 ("Preference will be given to those projects that most directly contribute to specific economic objectives, such as . . . strengthening of infrastructure . . . ."); *see also Comprehensive Tax Reform, Part 6*, *supra* note 9, at 4990 (proposal by Gov. Hernández Colón of Puerto Rico to use § 936 funds to build processing plants in Dominica to prevent fruit from rotting on the trees).

trade incentive on sugar[171] provides an example of congressional protectionism. While granting the CBI nations duty-free treatment, Congress continued to maintain price supports on domestic sugar in the face of decreasing demand. Congress was then forced to cut quotas on Caribbean Basin sugar due to the flood of domestic sugar on the market.[172]

In addition to Congress' current protectionist sentiments, CBI supporters blame protectionism at the time of the passage of the CBI for its present ineffectiveness. Many CBI supporters feel that the program cannot succeed unless excluded trade items, such as textiles, apparel, and leather products, are given duty-free treatment.[173] These items are typically labor-intensive, and could be produced in the Caribbean Basin at less cost than they are currently being produced in the Far East.[174] Unless CBI nations gain some sort of competitive advantage in the world market, they will not be able to compete with the Far East.[175]

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[171] 19 U.S.C. § 2703(c) (Supp. 1985); *see supra* note 82 and accompanying text.

[172] *See* Cullen, *supra* note 2, at 44; *see also CBI and U.S. Minority Participation*, *supra* note 76, at 13 (describing "widespread concern in the region about the direction of our sugar policy"). The United States Government later determined that the quotas could not be altered in favor of CBI sugar products without violating the General Agreement on Tariffs and Trade (GATT). *Review of the CBI*, *supra* note 2, at 52. Costa Rica's floricultural market suffered a similar fate as a result of action by the Commerce Department's International Trade Administration. DELEGATION MISSION REPORT, *supra* note 12 at 16, 67; Cullen, *supra* note 2, at 44. For a general discussion on the vulnerability of CBI imports to protectionist pressure, see *Review of the CBI*, *supra* note 2, at 440-45 (statement of Craig VanGrasstek, Trade Policy Consultant).

[173] *CBI and U.S. Minority Participation*, *supra* note 76, at 1, 71; ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 18; *Dilemmas of Caribbean Development*, *supra* note 40, at 257. At the time of the passage of the CBI, 87% of Caribbean exports were already entering the United States duty-free. A. PAYNE, *supra* note 2, at 62. Of the remaining 13%, approximately one-half consisted of textiles and clothing (excluded under the CBI), and sugar (subject to a global quota system with no preferences for CBI countries). *Id.* Combined with the other excluded items, the impact of the CBI on Caribbean exports is negligible. *See, e.g.*, Pastor, *supra* note 2, at 1045 (estimating that during the first year of the CBI, the increase in exports to the United States will amount to only one percent of existing levels); Romero, *supra* note 90, at 548 (stating that in 1983 only four percent of total Caribbean exports to the United States were eligible for concessions under the CBI). In addition, protection of domestic textile markets seems unreasonable when one realizes that Caribbean companies possess a very small share of the textile market. *See CBI and U.S. Minority Participation*, *supra* note 76, at 14.

The most promising application of the CBI may be in non-traditional areas. *See* GUIDEBOOK, *supra* note 6, at 3 ("Promising areas for U.S. investment include tropical fruits, winter vegetables, wood products, horticulture, aquaculture, food processing, livestock, tourism, data processing . . . and export oriented light manufacturing . . . ."); Braveboy-Wagner, *supra* note 16, at 168-69 (stating that President Reagan's purpose in promoting the CBI was not to encourage duty-free treatment of traditional exports, but rather to encourage Caribbean nations to develop new products for export) (citing N.Y. Times, Feb. 25, 1982, at A14).

[174] Wylie, *supra* note 12, at 3-4.

[175] DELEGATION MISSION REPORT, *supra* note 12, at 5-6 (stating that CBI nations' exports of textiles and apparel were negligible compared to those of the Far

Moreover, protectionist barriers imposed by governmental agencies on Caribbean Basin nations may negate any benefits derived from the CBI.[176]

The CBI is a long-range program: as discussed in Section 2.2, duty-free treatment of CBI imports is intended to last twelve years.[177] Although the CBI's delicate balance was designed to prevent investment from happening too quickly, many critics believe that too much red tape bars the implementation of CBI incentives.[178] Furthermore, an additional surge of protectionism in Congress against CBI nations could prevent the new investment incentives from providing any lasting economic development.

4.1.4. Additional Problems of Development Under the CBI

CBI supporters have noted additional problems with implementing the CBI in poorer countries. Rushing to manufacturing too fast often results in a waste of agricultural resources.[179] Where a country would have produced its own vegetables, the CBI and the Twin Plant Program might encourage it to invest in manufacturing; the little income that the developing nation then earns from foreign investment must be used to import food which it had formerly produced.[180]

Overconservatism on the part of Caribbean and United States investors also detracts from the effectiveness of the CBI. Local investors often impose extremely high interest rates and 100% collateral requirements on borrowers.[181] The increased availability of section 936 funds, however, is projected to drive interest rates down.[182] The CBI nations

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East).

[176] *See* Cullen, *supra* note 2, at 44; *see also* Comment, *supra* note 36, at 272-76 (stating that a country's status as a CBI beneficiary country has no effect on a decision by United States Customs to impose countervailing duties on its exports, and noting that a steel plant in Trinidad & Tobago and a cement plant in Costa Rica were subject to countervailing duties in spite of the conditions of the CBI).

[177] *See supra* note 68 and accompanying text; *CBI and U.S. Minority Participation*, *supra* note 76, at 5 (stating that in 1985 the program had been operating for less than 2 years out of the 12, and that protectionism must be avoided).

[178] Field, *Treasury Spells Out New Caribbean Tax Incentives*, 14 TAX NOTES, Mar. 22, 1982, at 774.

[179] The decline of the agricultural sector in CBI countries has increased the flow of migration to the United States from Caribbean countries. Workers unable to support themselves in agriculture move first to the cities of their own countries, and, then, failing to find work there, seek to enter industrialized countries such as the United States. *See* Pastor, *supra* note 2, at 1055.

[180] *See CBI and U.S. Minority Participation*, *supra*, note 76, at 23. For additional problems of developing the agricultural sector of Caribbean Basin countries, see *Dilemmas of Caribbean Development*, *supra* note 40, at 263-64.

[181] *See* EASTERN CARIBBEAN REPORT, *supra* note 40, at 21.

[182] *See* Metzger, *Financing Trade Between Puerto Rico and the CBI Region*, 10

also exhibit conservatism in production, preferring to limit themselves to traditional commodities rather than developing new export opportunities.[183] Exports of traditional commodities have already declined from 1984 to 1985, while exports of non-traditional items have grown at higher than the worldwide rate.[184] These conservative investment practices persist in spite of the grim outlook for traditional Caribbean exports for the rest of the decade.[185] United States investors also exhibit conservatism by investing only in countries with established infrastructures and stable governments, bypassing countries that have the greatest need for private investment.[186] Caribbean and United States investors must shed some of their conservatism and take some risks in order for the CBI and the Twin Plant Program to be successful.

In addition, many CBI nations continue to place restrictions on foreign investment.[187] These restrictions include tax structures which discourage foreign investment,[188] overvalued exchange rates,[189] and inadequate foreign exchange for imported materials.[190] By creating environments hostile to foreign capital, CBI countries can produce obstacles to Caribbean development that are as great as United States protectionist barriers.[191]

4.2. *Improving the Effectiveness of the CBI*

Congress has been aware of the CBI's shortcomings since the CBI's inception in 1983, and has attempted to improve its effectiveness.

P.R. BUS. REV., Aug.-Sept. 1985, at 6-7 (stating that interest rates on § 936 funds are sometimes one to two percent lower than Eurodollar rates).

[183] *CBI and U.S. Minority Participation, supra* note 76, at 4.

[184] *Id.* at 9-10.

[185] *Id.* at 52; *see* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 27.

[186] *See supra* notes 156-61 & 170 and accompanying text.

[187] *See CBI and U.S. Minority Participation, supra* note 76, at 54; *see also* ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 16 ("[T]he success of [foreign capital] is predicated upon the functioning of a political system that is accommodating to foreign capital."). *But see CBI and U.S. Minority Participation, supra* note 76, at 42-43 (discussing efforts by CBI countries to institute macroeconomic changes and improve foreign investment laws so that investment is encouraged rather than restricted).

[188] *CBI and U.S. Minority Participation, supra* note 76, at 54. The tax rates of Caribbean nations tend to be much higher than those of capitalist Far Eastern countries such as Singapore, Hong Kong, and Taiwan. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 23; *see also* President Reagan's Grenada speech, *supra* note 136.

[189] *CBI and U.S. Minority Participation, supra* note 76, at 54 ("[O]vervalued exchange rates are the greatest single obstacle to export expansion and diversification.").

[190] *Id.*

[191] Protectionist import substitution policies in Caribbean nations also cause local businessmen to become unable to handle competitive markets. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 27.

In February of 1986, the House Subcommittee on Oversight of the Committee on Ways and Means held hearings to review the impact and effectiveness of the CBI (Hearings).[192] Many provisions of the CBI were of great concern, particularly the problems of the Caribbean sugar industry[193] and the overall decline in trade from the Caribbean Basin to the United States since the CBI's inception.[194] Various options were explored by members of the House Subcommittee, United States and Caribbean Basin officials, and people in the private sector, to reduce problems in the Caribbean. The section 936 investment incentives and the Twin Plant Program were discussed in some detail.[195] Among the proposed improvements to the CBI were expansion of the CBI to include other investing countries, such as Canada and the European countries, the continued development of new, non-traditional exports, expansion of duty-free treatment to restricted or exempt items, and extension of the time frame of the CBI beyond the original twelve-year time limit.

Following these Hearings, the Subcommittee on Oversight sent a delegation mission to five Caribbean Basin countries[196] to determine the progress of the CBI countries toward attaining economic development and the role of the CBI in achieving such development.[197] The delegation mission visited the Caribbean Basin during January 10-21, 1987. The five countries visited shared many of the same concerns. From the trade perspective, these countries were interested in expanding the product coverage under the CBI to include textiles, leather goods, and tuna.[198] They also desired a reduction in sugar quotas,[199] and expressed fear of growing protectionism in the United States.[200] From the tax perspective, these countries were eager to receive section 936 funds to

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[192] *Review of the CBI*, *supra* note 2.

[193] *Id.* at 52.

[194] *Id.* at 65 (statement of B. Smart, Under Sec'y of Commerce). Total exports from CBI countries to the United States declined from $9.5 billion in 1983 to $7.3 billion in 1985, a decline of 23%. The decline, however, was believed to be largely attributable to the decline in petroleum product prices. *Id.*; *see also* DELEGATION MISSION REPORT, *supra* note 12, at 94 (excluding oil-exporting CBI nations, total United States imports from the Caribbean Basin during this period increased from each of the three CBERA regions — 13.4% from Central America, 15.9% from the Central Caribbean, and 19.0% from the Eastern Caribbean. In the same period, however, United States imports from the world grew by 33.8%.).

[195] *Review of the CBI*, *supra* note 2, at 147 (statement of Stephen E. Shay, Acting Int'l Tax Counsel, Dept. of the Treas.).

[196] Jamaica, Costa Rica, Barbados, Dominican Republic, and Haiti. DELEGATION MISSION REPORT, *supra* note 12, at 7.

[197] *Id.*

[198] *Id.* at 13, 17, 22, 29.

[199] *Id.* at 12, 15, 19, 21, 24.

[200] *Id.* at 13, 16.

enhance their developmental projects, but were reluctant to sign tax information exchange agreements (TIEAs).[201] Overall, these five countries were anxious to increase Caribbean Basin access to United States markets[202] and to extend the coverage of the CBI beyond the initial twelve-year period.[203]

Based on its observations, the delegation mission made several recommendations for improving the CBI. The first recommendation was the reaffirmation of the congressional commitment to the success of the CBI.[204] Moreover, the delegation recommended: (1) an extension of the CBI beyond its 1995 expiration date,[205] (2) duty-free access to articles assembled or processed from parts made in the United States,[206] (3) duty-free treatment of dutiable "exempt list" products where the article is not produced or is in short supply in the United States,[207] (4) duty-free treatment of specific amounts of "exempt list" dutiable goods exported to the United States under a "tariff rate quota" system,[208] (5) separate injury determinations in countervailing duty and anti-dumping unfair practice cases,[209] (6) a $200 increase in the duty-free allowance for United States citizens returning from a CBI beneficiary country,[210] and (7) the establishment of a "rule-of-origin" to provide total duty-free treatment for products substantially transformed in the Eastern Caribbean states.[211] The delegation also recommended that the Sub-

[201] *Id.* at 25, 28. Of the five countries visited, Costa Rica, the Dominican Republic, and Haiti had not yet signed TIEAs. *Id.* at 9.

[202] *Id.* at 14, 17, 20, 22, 26.

[203] *Id.* at 14, 22, 26.

[204] *Id.* at 36.

[205] *Id.* at 37. The delegation mission recommended automatic renewal of the 12-year period every year, effectively retaining a constant 12-year program until Congress affirmatively acted to phase out the CBI altogether. This recommendation also supported a reporting by CBI beneficiary countries every two or three years concerning use and promotion of the CBI, changes in government policies, and use of the tax benefits under the CBI. *Id.*

[206] *Id.* This provision would encourage production-sharing operations between United States and Caribbean Basin industries by eliminating the duty otherwise paid on the "value-added" portion of the item assembled in the CBI country.

[207] *Id.* at 37-38.

[208] *Id.* at 38-39.

[209] *Id.* at 39-40. This provision is an attempt to solve the problem of the Costa Rican cut flower industry. *Id.* at 40; *see supra* note 172.

[210] *Id.* at 40. This provision would help tourism in the Caribbean Basin and encourage visitors to purchase goods in the region.

[211] *Id.* at 40-41. The proposed rule of origin "allow[s] products from the Eastern Caribbean States to enter the United States duty-free if (a) 25 percent of the value of the product is U.S. components, and 10 percent is value-added in the Eastern Caribbean States; and, (b) the product is substantially transformed in the Eastern Caribbean States." *Id.* at 40. *Cf.* CBERA, 19 U.S.C. § 2703(a) (Supp. 1985). The Eastern Caribbean States include Anguilla, Antigua and Barbuda, Aruba, British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat, Netherlands-Antilles, St. Christo-

committee on Trade conduct hearings to resolve a number of issues deemed problematic by the delegation.[212] Finally, the report states the need for more assistance for infrastructure development[213] and desires the increase of government procurement contracts to businesses in CBI beneficiary countries.[214]

Based on these recommendations, a bill was introduced in the House of Representatives to amend and improve the CBI.[215] This bill generally endorsed the recommendations of the delegation mission.[216] At the time of publication of this Comment, this bill was still in the House Ways and Means Committee.

Although problems with the CBI remain, Congress seems firmly committed to making the CBI work. Obstacles for Caribbean Basin economic development have been strictly scrutinized, and solutions have been recommended. Should the CBI continue to receive support in the United States Congress and from United States administrative agencies, the Caribbean Basin is likely to continue to experience improvement in economic development, private investment, and trade.

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pher-Nevis, St. Lucia, St. Vincent and the Grenadines, and Turks and Caicos Islands. DELEGATION MISSION REPORT, *supra* note 12, at 40-41.

[212] 2. Subcommittee Hearings

a. The Subcommittee on Trade should conduct hearings to reexamine the U.S. trade policy underlying the exemption of certain items from duty-free treatment under the CBI.

b. The Subcommittee on Trade should determine whether the tax treatment afforded to certain U.S.-owned ethanol producers in the Caribbean region should also be afforded to state-owned facilities in Costa Rica and Jamaica.

c. The Subcommittee on Trade should hold hearings to determine whether the U.S. Customs Service handling and tariff treatment of CBI exports is consistent at each port of entry.

d. The Subcommittee on Oversight should hold hearings at the end of 1988 to provide review of loans made by the Government of Puerto Rico with . . . QPSII funds in qualified Caribbean Basin countries. In addition, the Government of Puerto Rico should report to the Committee on Ways and Means the results of its commitment to provide $100 million to qualified CBI countries.

DELEGATION MISSION REPORT, *supra* note 12, at 41.

[213] The infrastructure development should pay particular attention to the Eastern Caribbean States, Haiti, and the Central American countries, including Belize. *Id.* at 44-45.

[214] *Id.* at 46. This action is necessary because, although the Department of Commerce claims that the government procurement contracts are available to CBI investors, CBI investors are uncertain as to the applicability of the terms of these contracts to non-United States businesses.

[215] H.R. 3101, 100th Cong., 1st Sess. (1987).

[216] *Id.* The major exceptions include a provision for changing the termination date for duty-free treatment from 1995 to 2007, *id.* § 6, and a provision for freezing the quantity of sugar imports from beneficiary countries at levels prescribed from September 26, 1983, to September 30, 1984. *Id.* § 10.

5. Impact of Amended Section 936 and the Twin Plant Program on Puerto Rico

Although the investment produced by section 936 provides few jobs for Puerto Rican workers, most Puerto Ricans believe their economic situation would be much worse without section 936.[217] Section 936 presents a classic dilemma: Puerto Rico has become so dependent on section 936 for investment that it feels that its economy cannot survive without it, while a growing number of Washington constituents feel that the national budget can no longer afford to support the costly investment incentive.[218] Politically, Puerto Rico has become mired in its Commonwealth status, which fails to provide the Puerto Rican people with either adequate representation or adequate self-determination.[219] Although the retention of section 936 and the addition of the Twin Plant Program attempt to solve some of the abuses of the tax credit and to give Puerto Rico some autonomy, Puerto Rico's economic dependence on section 936 and the United States will prevent the island from reaping any long-term benefits.

5.1. Puerto Rico's Economic Problems

The economic problems of other Caribbean nations[220] are shared by Puerto Rico. Although Puerto Rico has a good infrastructure and educational system,[221] it also has many seemingly insurmountable obstacles to economic growth. Unemployment on the island fluctuates between twenty and twenty-five percent;[222] the majority of the Puerto Ri-

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[217] *Tax Breaks*, *supra* note 12, at 20.

[218] Turner, *Is It Time to End Puerto Rican Tax Haven?*, J. Com., July 11, 1985, at 15A, col. 1.

[219] *See infra* notes 250-52 and accompanying text.

[220] *See supra* notes 36-40 and accompanying text.

[221] *See* Puerto Rico and the CBI, *supra* note 131, at 5.

[222] *See* Rublin, *supra* note 102, at 6 (estimating Puerto Rican unemployment to be about 20% as of March 1986); 131 Cong. Rec. E1485 (daily ed. Apr. 16, 1985) (statement of Hon. Jaime B. Fuster); *Comprehensive Tax Reform, Part 6*, *supra* note 9, at 4987 (statement of Gov. Hernández Colón). Economists argue that Puerto Rico's unemployment rate would be even higher if the public sector did not employ significant numbers of people to do trivial tasks. *See* Rivera, *supra* note 95, at 150; *see also Comprehensive Tax Reform, Part 9*, *supra* note 106, at 9105 (stating that even with § 936, unemployment is expected to rise to 27% by 1990); *id.* at 9106 (letter from Prof. José Felíx Resto to Hon. Joseph K. Dowley) (stating that chronic unemployment causes an increase in Puerto Rican migration to mainland United States). Interestingly, other possessions benefitting from § 936 do not have an unemployment problem. In both the Virgin Islands and American Samoa, unemployment stands at approximately 5.8%, lower than United States mainland unemployment. *Comprehensive Tax Reform, Part 6*, *supra* note 9, at 4972-73.

can people depend on food stamps.[223] The oil crisis of the late 1970s hurt Puerto Rico far more than it hurt the United States.[224] Puerto Rico also suffers from a competitive wage disadvantage: workers in Puerto Rico do not compete with workers in the United States, but rather compete against lower wage workers in Third World countries in the Caribbean, the Far East, and similar areas.[225] Puerto Rico's higher wages and more highly skilled workforce often disadvantage rather than aid the island under these circumstances.

Although Section 936 continues to be lauded by Puerto Rican leaders, its continuing existence, despite the addition of the Twin Plant Program, may not improve Puerto Rico's economic condition. In fact, critics of section 936 assert that, contrary to helping Puerto Rico achieve economic growth, implementation of section 936 actually aggravates the island's worsening economic condition.[226] The rush to manufacturing encouraged by section 936 and Puerto Rican tax exemption has left Puerto Rico's agriculture in a deplorable state.[227] Furthermore,

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[223] A. PAYNE, *supra* note 2, at 17; Costas Elena, pt. 1, *supra* note 89, at 570; Tansill, *supra* note 22, at 99 (stating that 7 out of every 10 Puerto Rican households receive food stamps); Tax Breaks, *supra* note 12, at 20. The increased dependence of Puerto Ricans on the United States welfare system only increases Puerto Rico's dependence on the United States as a whole. García-Passalacqua, *supra* note 22, at 279. One critic argues that federal budget cuts in welfare programs will have "a much more devastating and lasting impact" than will a revision of § 936. *Id.* at 281. Puerto Rico's lack of adequate representation in Congress, however, prevents the Puerto Rican people from having any say in federal budget cuts of welfare and food stamp programs affecting them. *See id.*; *infra* note 250 and accompanying text.

[224] The island depends on imported oil for almost all of its energy needs. At the time of the crisis, for example, Puerto Rico was using oil for 93% of its energy needs, while the comparable dependence rate for the mainland United States was 16%. Tansill, *supra* note 22, at 98. Puerto Rican dependence on imported oil has been estimated to be as high as 99%. A. PAYNE, *supra* note 2, at 17; *see also Tax Reform Act of 1986, Part III*, *supra* note 99, at 1378; *Comprehensive Tax Reform, Part 9*, *supra* note 106, at 9102.

[225] *See* 131 CONG. REC. E1360 (daily ed. Apr. 4, 1985) (letter from Bill Richardson, Chairman of the Congressional Hispanic Caucus). These countries' lack of, e.g., minimum wage laws and environmental laws, which the United States has imposed in Puerto Rico, would make these places a comparatively more favorable environment for investment were it not for § 936. *Id.*

[226] *See* Costas Elena, pt. 1, *supra* note 89, at 569-72 (discussing effects of tax exemptions on employment, interest rates, and concentration of wealth in Puerto Rico); Rivera, *supra* note 95, at 147-67 (discussing § 936 effects on overall Puerto Rican economy); *see also* Sheridan, *Puerto Rico: Commonwealth, Independence, or Statehood?*, 40 REV. COL. AB. P.R. 291, 294 (1979) (stating that supporters of independence believe that Puerto Rico's economic problems are caused by United States capital on the island).

[227] Pastor, *supra* note 2, at 1051 (stating that, as a result of Operation Bootstrap, Puerto Rico lost more jobs in agriculture than it gained in manufacturing); Rivera, *supra* note 95, at 146; Tansill, *supra* note 22, at 98-99; *cf. CBI and U.S. Minority Participation*, *supra* note 76, at 23 (statement of Lawrence Theriot) (stating that other Caribbean nations suffer from the same problem). *But see* Martin, *supra* note 56, at 7

the hopes that Puerto Rican leaders placed on the influx of United States manufacturing to deliver the island from poverty have not succeeded.[228] Although initially the section 936 corporations employed thousands of Puerto Rican people, total employment in manufacturing has remained constant since 1973.[229]

In addition, section 936 and Puerto Rican tax incentives to United States corporations have created tax inequities in Puerto Rico, especially the overtaxation of Puerto Rico's middle class. The middle class of Puerto Rico is taxed at a higher marginal tax rate than the middle class of the United States, while large corporations pay little or no tax at all.[230] The continuation of section 936 also creates problems for local Puerto Rican investment. Unlike section 936 companies, Puerto Rican companies are taxed on their income in Puerto Rico.[231] This situation tends to discourage local Puerto Rican investment and entrepreneurial activity.[232]

Finally, some critics fault section 936 because of its misplaced focus. They believe section 936 has accommodated the desires of foreign investors, rather than protecting and promoting the interests of the Puerto Rican people.[233] Because of worsening economic problems and the

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(stating that for Puerto Rico to have an efficient agricultural economy would require "a level of output per acre far beyond the realm of possibility").

[228] At the time of the proposed repeal of § 936 in 1985, 63% of the Puerto Rican population was living below the 1985 poverty level. 131 CONG. REC. E1360 (daily ed. Apr. 4, 1985) (letter from Bill Richardson, Chairman of the Congressional Hispanic Caucus); *see also* 131 CONG. REC. E4631 (daily ed. Oct. 16, 1985) (statement of Hon. Fuster) (discussing the shantytowns where many Puerto Ricans still live); Costas Elena, pt. 2, *supra* note 89, at 148 ("To the average Puerto Rican the benefits of I.R.C. section 936 have not trickled down.").

[229] Treasury Department, *supra* note 14, at 328; Martin, *supra* note 56, at 8. Approximately 6.5% of Puerto Ricans work in manufacturing, compared to 11% in the mainland United States. An 11% rate of manufacturing employment in Puerto Rico would produce 100,000 new jobs. *Id. But see* Highley, *Sec. 936 Still Spurs Industry*, J. Com., June 7, 1983, at 13, col. 3 ("From 1970 to 1980, manufacturing employment increased by 13.1%, [a growth rate] which is 2.8 times as fast as . . . mainland manufacturing employment . . . .").

[230] *See* Costas Elena, pt. 3, *supra* note 89, at 240-41; Costas Elena, pt. 1, *supra* note 89, at 571. Even though Governor Hernández Colón has implemented tax reform, maximum personal income tax rates are still as high as 50%, compared to the United States maximum rate of 28% for individuals and 33% for corporations. *See* Rublin, *supra* note 102, at 7.

[231] *See* Costas Elena, pt. 1, *supra* note 89, at 234, 240-41.

[232] *See id.* at 234 (stating that tax-exempt businesses in Puerto Rico compete unfairly with taxable Puerto Rican corporations); Martin, *supra* note 56, at 7-8 ("Of the roughly 150,000 jobs in manufacturing, no more than 40,000 are employed in plants that are locally owned."). *But see Comprehensive Tax Reform, Part 6, supra* note 9, at 5021 (stating that existence of § 936 helps train Puerto Rican workers to become emerging entrepreneurs).

[233] Costas Elena, pt. 4, *supra* note 89, at 625-30. Costas Elena seems to prefer some sort of quid pro quo system by which tax-exempt companies in Puerto Rico

failure of section 936 as a model of development,[234] the continuation of section 936 only perpetuates the economic dependence of Puerto Rico on the United States.[235] The island economy depends greatly on the influx of United States investment. Should the United States repeal section 936, Puerto Rico would be faced with the migration of its people to the mainland and the adoption of an extended public works program.[236]

The dangers of Puerto Rican dependence are numerous. First, dependence on the United States causes the Puerto Rican economy to be much more susceptible to recessions on the United States mainland.[237] Second, Puerto Rico has no industrial development programs of its own: industrial development on the island centers on the attraction of United States investment through United States and Puerto Rican tax incentives.[238] Finally, Puerto Rico's status as a Commonwealth[239] makes economic dependence on the United States more dangerous: with no adequate representation in Congress, Puerto Rico has little say in its own development.[240]

Since his inauguration as Governor of Puerto Rico in 1985, Hernández Colón has sought to reduce Puerto Rico's dependence on the United States. His efforts have included personal tax reform and banking reform, as well as implementation of the Twin Plant Program.[241] However, it is not likely that his attempts at economic independence

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would receive exemption based on investment rather than on profit.

[234] *See generally* Lewis, *The Failings of Operation Bootstrap*, in 1 READINGS IN CARIBBEAN HISTORY AND ECONOMICS: AN INTRODUCTION TO THE REGION 262 (R. Delson ed. 1981) (discussing the disappointing outcome of efforts to improve the Puerto Rican economy by means of tax preferences and industrial development).

[235] *See* Costas Elena, pt. 4, *supra* note 89, at 630-33; *id.* at 630 (Fomento income tax exemptions "have *increased* not decreased Puerto Rican economic dependency.") (emphasis added).

[236] For a discussion of the deficiencies of these alternatives, see Lewis, *supra* note 234, at 267-68.

[237] *Id.* at 268.

[238] The Twin Plant Program attempts to reduce this dependence by giving some autonomy to Puerto Rico to attract investment to CBI nations. *See Government Development Bank Loan Policies*, *supra* note 137, at 8.

[239] *See infra* Section 5.2.

[240] *See* Lewis, *supra* note 234, at 269 (discussing the extent to which Puerto Rico is already dependent on the United States Congress and federal regulatory agencies for such matters as air traffic, shipping, immigration control, and postal communications).

[241] *Compare* P.R. LAWS ANN. tit. 13, §§ 3011-3012 (1978) *with* P.R. LAWS ANN. tit. 13, § 3011(a) (Supp. 1986) (reducing highest marginal tax rate from 72% to 50% for taxable years commencing after December 31, 1985). *See* Rublin, *supra* note 102, at 7 (the maximum personal income tax rate has been lowered to 50%; that on savings deposit interest to 17%); Martin, *supra* note 56, at 9 (stating that the present tax system encourages "the flight of capital from the island" and that Gov. Hernández Colón's number one priority is to create jobs to reduce dependence on section 936 companies).

will succeed under the present system. As long as Puerto Rico remains a Commonwealth, economic dependence is likely to continue.[242] Moreover, the United States has discouraged Puerto Rico from attempting to attract foreign nations to invest in the island.[243] Although to some extent Puerto Rico has enjoyed benefits from its dependence on the United States, continued dependence will only serve to narrow markets which Puerto Rico could otherwise reach[244] and postpone any Puerto Rican notions of self-determination.

5.2. *Puerto Rico's Political Status and Status Alternatives*

Puerto Rico has governed itself as a Commonwealth of the United States since 1952.[245] As Commonwealth citizens, many Puerto Ricans feel they have the best of both worlds: they enjoy United States citizenship[246] which allows them to migrate to the mainland without immigration restrictions,[247] while they retain their language and culture. The development of section 936, moreover, is dependent on the development of Puerto Rico as a Commonwealth; if Puerto Rico's political status changed, it would lose its section 936 tax credit and thus its most effective means of drawing investment.[248]

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[242] *See* Lewis, *supra* note 234, at 269.

[243] *See Tax Breaks*, *supra* note 12, at 20; *see also* Rublin, *supra* note 102, at 7 (discussing Gov. Hernández Colón's efforts to attract Japanese investment).

[244] *See* Lewis, *supra* note 234, at 269.

[245] The law establishing Puerto Rico as a Commonwealth was passed by Congress on July 3, 1950. An Act to Provide for the Organization of a Constitutional Government by the People of Puerto Rico, Pub. L. No. 81-600, 64 Stat. 319 (1950) (codified at 48 U.S.C. §§ 731b-731e (1982)). The Act was approved by a referendum of the Puerto Rican people on June 4, 1951. A delegation was then formed to establish a Constitution of the Commonwealth; the Constitution was approved by the Puerto Rican people and Congress and put into effect on July 25, 1952. *See* Tansill, *supra* note 22, at 91. For a history of the United States occupation of Puerto Rico prior to Commonwealth status, see Geyls, *supra* note 23, at 410-36.

[246] Puerto Ricans were granted the status of United States nationals by the Foraker Act, ch. 191, § 7, 31 Stat. 77, 79 (1900) (codified as amended at 48 U.S.C. § 733 (1982)), and were granted full United States citizenship in 1917 by the Jones Act, ch. 145, § 5, 39 Stat. 951, 953 (1917) (codified as amended at 48 U.S.C. § 733a (1982)). Conferral of United States citizenship was objectionable to many Puerto Rican leaders who feared that such citizenship would be a hindrance to any Puerto Rican independence efforts. *See* Tansill, *supra* note 22, at 87.

[247] Moreover, if a Puerto Rican migrates to the United States and meets one of the states' voting registration requirements, she can vote for federal and state candidates for office, a privilege she would not have as a citizen of one of the 50 states residing in Puerto Rico. Tansill, *supra* note 22, at 92.

[248] Should Puerto Rico become independent, it would most likely lose the benefits of § 936. Independence would put Puerto Rico outside of the United States tariff system, hence making investment there less profitable for United States companies. Sheridan, *supra* note 226, at 295. If Puerto Rico became a state, the United States Constitution would require that taxation of Puerto Rican corporations be equivalent to that of

Puerto Rico's Commonwealth status has its disadvantages. Although Puerto Rico has several advantages of association with the United States such as citizenship and section 936,[249] it lacks essential privileges which states enjoy, such as adequate representation in Congress.[250] Furthermore, because of Puerto Rico's lack of independence, its investments are not protected by trade treaties with the United States.[251]

Whether they advocate Puerto Rican statehood or independence, many commentators view Puerto Rico's Commonwealth position as a second-class status.[252] In addition, other nations view Puerto Rico's Commonwealth status as a temporary status, and have asked the United Nations for assistance in clarifying this issue.[253]

United States corporations in other states, and § 936 would accordingly have to be repealed. Highley, *Puerto Rican Tax Plan Raises Legal Questions*, J. Com., Dec. 18, 1984, at 5A, col. 1; O'Reilly, *Economy Set to Rebound as US Recovery Begins*, J. Com., June 7, 1983, at 1, col. 1.

[249] Other advantages enjoyed by Puerto Rico because of its association with the United States include federal grants-in-aid to the island, food stamps, federal postal and currency systems, and access to the United States Supreme Court as final arbiter of Puerto Rican disputes. Tansill, *supra* note 22, at 93, 99. In addition, most of the provisions of the United States Constitution are applicable to Puerto Rico. Geyls, *supra* note 23, at 433. Moreover, Puerto Rican individuals, because they are not citizens of one of the 50 states, pay no United States income taxes (although Puerto Rican individual income taxes are generally higher than those on the mainland). *Id.*; Costas Elena, pt. 3, *supra* note 89, at 242.

[250] Puerto Rico actually enjoyed more representation under Spanish monarchy than it has ever had under United States democracy. Under Spanish rule in the 1890s, Puerto Rico sent 20 delegates to the Spanish Cortes, each having " 'full power to vote [and] . . . represent their people.' " Tansill, *supra* note 22, at 83 (quoting 36 CONG. REC. 292 (1963) (remarks of James L. Sloyden)). *See* L. LANGLEY, *supra* note 23, at 157. As a Commonwealth of the United States, Puerto Rico has never had a representative in the United States Senate, and until 1902 did not have a representative in the United States House of Representatives. Tansill, *supra* note 22, at 85-86. Currently, Puerto Rico's representative to the House may speak on the floor, but cannot vote there, although he may vote in committee. *Id.* at 93. Furthermore, Puerto Rico's Governor was appointed by the President until 1948, at which time Puerto Rico held its first popular election. *Id.* at 90.

This lack of representation was especially critical during the Treasury Department's recent attempt to repeal § 936, *see supra* Section 3.2.1 and accompanying notes, and replace it with a wage credit: the Governor of Puerto Rico was not even consulted concerning the proposed repeal. *Comprehensive Tax Reform, Part 6, supra* note 9, at 5003.

[251] *See* O'Reilly, *Puerto Rico Optimistic On Keeping Tax Benefits*, J. Com., Oct. 9, 1985, at 4A, col. 3.

[252] *See* 131 CONG. REC. S8755 (daily ed. June 25, 1985) (statement of Sen. Simon). Historically, the Puerto Rican people have not sought independence, but, rather, simple dignity in whatever status they held, whether as a Spanish colony or as a United States possession. *See* Sheridan, *supra* note 226, at 295 ("Neither statehood nor independence advocates believe that [dignity] is provided by Commonwealth status."); Tansill, *supra* note 22, at 83.

[253] Since the late 1970s, Latin American countries including Venezuela have made repeated statements in the United Nations calling for the decolonization of Puerto Rico.

The advocates of Puerto Rican statehood[254] insist that statehood is the only means by which Puerto Rico can assure itself of keeping benefits that Congress has conferred upon it.[255] They further argue that the Commonwealth status is not a permanent status,[256] but rather a throwback to nineteenth century colonialism.[257] They fear the independence movement, believing that it will drive Puerto Rico away from the United States and ally it with enemy forces in the Caribbean.[258]

Critics of the statehood alternative argue that if Puerto Rico became a state, the Puerto Rican people would lose their language and culture.[259] They further argue that Puerto Rico's economic problems are strictly local in nature, and Puerto Rico needs to retain local autonomy in order to properly deal with the unique nature of these problems.[260]

Advocates of Puerto Rican independence believe that independence is the best way to stabilize Puerto Rico economically, stop terrorism, and give Puerto Rico a constructive position in the Caribbean Basin.[261] They believe, as do the statehood advocates, that the Commonwealth status is not permanent, and, unless the United States becomes more responsive to Puerto Rican unrest, the United States could be confronted with political unrest such as that which exists in Northern Ire-

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García-Passalacqua, *supra* note 22, at 290-91.

[254] As recently as April 1986, advocates of Puerto Rican statehood have petitioned the United States Congress for hearings on this matter. 132 CONG. REC. H1807 (daily ed. Apr. 14, 1986).

[255] *Status of Puerto Rico, Hearings before the United States-Puerto Rico Commission on the Status of Puerto Rico*, 89th Cong., 2d Sess. 178 (1965) [hereinafter *Status Hearings*] (statement of Dr. Santos Amadeo).

[256] *Id.*; *see* Geyls, *supra* note 23, at 445 ("[T]he United States has not . . . given a final solution to the status of Puerto Rico, either by making it a part of the Union or recognizing it as a sovereign nation."). After approving Puerto Rico's Commonwealth status, the United States Congress declared that it "did not intend to settle, once and for all, the status of the island." Tansill, *supra* note 22, at 92.

[257] *Status Hearings*, *supra* note 255, at 155 (stating that Puerto Rico under Commonwealth status remained a territory or possession of the United States).

[258] *Id.* at 163.

[259] *See* Sheridan, *supra* note 226, at 295 (stating that "it is not clear how receptive Congress would be to the admission of a largely Spanish-speaking state"); *see also* García-Passalacqua, *supra* note 22, at 276. *But see Status Hearings*, *supra* note 255, at 82 (stating that, should Puerto Rico become a state, it could continue its bilingual culture); *id.* at 124 (stating that the right of Puerto Ricans to speak Spanish is protected by the United States Constitution).

[260] *Status Hearings*, *supra* note 255, at 195 (statement of Raphael Hernández Colón). One of Puerto Rico's economic problems is its low per capita income: although Puerto Rico's economic situation is much better than those of its Caribbean neighbors, Puerto Rico's per capita income is "less than one-half of that of the poorest state of the Union." *Tax Reform Act of 1986, Part 9*, *supra* note 106, at 1324; *Hearings on the CBI*, *supra* note 66, at 54.

[261] *See* García-Passalacqua, *supra* note 22, at 294; Rivera, *supra* note 95, at 171; Sheridan, *supra* note 226, at 294.

land or Quebec.[262] Advocates of independence have gone so far as to ask the United States Congress for a report concerning the "decolonization" of Puerto Rico, delineating conditions under which Puerto Rico would become either a state or an independent country, or modification of the present Commonwealth to become a "Free Association."[263]

Critics of the independence movement point to its traditionally leftist leanings,[264] and resent outside groups such as the United Nations encouraging the independence movement.[265] Some opponents of Puerto Rican independence point out that Puerto Ricans, as United States citizens, cannot be deprived of their citizenship under the United States Constitution.[266]

In 1965, the United States Congress set up a Commission to discuss the nature of Puerto Rico's political status to the United States.[267] One of the principal determinations of this Commission was that the Puerto Rican people must take the first step toward any change in political status.[268] This process has typically taken place by means of a referendum requiring a supermajority of the Puerto Rican people to approve the change.[269] Not much has changed since 1965: if anything,

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[262] García-Passalaqua, *supra* note 22, at 293; *see also* L. LANGLEY, *supra* note 23, at 260-65 (arguing that Puerto Rico's domination by the United States makes its situation more akin to that of Ireland under British rule than to that of a typical Third World country).

[263] García-Passalacqua, *supra* note 22, at 291.

[264] *Cf. id.* at 278-79. Moreover, the independence movement in Puerto Rico has traditionally spawned violence and terrorism. *See* L. LANGLEY, *supra* note 23, at 261-62; García-Passalacqua, *supra* note 22, at 285-87; Sheridan, *supra* note 226, at 292; *see also* A. PAYNE, *supra* note 2, at 18 (discussing guerrilla activity in Puerto Rico led by the Macheteros, a pro-independence group).

[265] *Status Hearings*, *supra* note 255, at 123; Sheridan, *supra* note 226, at 292.

[266] Geyls, *supra* note 23, at 440. This position has been discounted by the results of the United States-Puerto Rican Commission's conclusion that all three status alternatives are constitutional. *See* REPORT OF THE UNITED STATES-PUERTO RICO COMMISSION ON THE STATUS OF PUERTO RICO 6 (1966) [hereinafter COMMISSION REPORT].

[267] Its findings were published as the COMMISSION REPORT, *supra* note 266; *see also* Tansill, *supra* note 22, at 94.

[268] COMMISSION REPORT, *supra* note 266, at 6-8; *see* García-Passalacqua, *supra* note 22, at 292 (stating that "the Puerto Ricans must make up their minds first" about their political status).

[269] Several referenda, or plebiscites, have been held, with no indication on the part of the Puerto Rican people of any desire to change from the Commonwealth status. In 1967, a plebescite was held, with the Commonwealth status winning 60.4% of the vote, statehood 33.9% and independence only 6.0%. Tansill, *supra* note 22, at 94; *see* Sheridan, *supra* note 226, at 292 (stating incorrectly that the independence supporters received only .06% of the vote).

At the time of Puerto Rico's establishment as a Commonwealth, political parties developed around Puerto Rico's commonwealth status and other status alternatives. *Tax Breaks*, *supra* note 12, at 20. The Commonwealth status is advocated by the Popular Democratic Party (PDP), the statehood alternative by the New Progressive Party

Puerto Rico's Commonwealth status has become even more deeply entrenched. One of the key determinations of the 1965-1966 Commission was that Puerto Rican economic growth had to be maximized in order for the people of Puerto Rico to assess the merits of each status alternative.[270] Because the possessions tax credit at the time of the Commission was an integral part of Puerto Rican economic development, it became an integral part of Puerto Rican status determination. The members of the Commission did not envision the development of the total interdependence of section 936 and Puerto Rico's Commonwealth status.[271] It is ironic, therefore, that the Commonwealth status is the only alternative which does not provide Puerto Rico with adequate representation to retain section 936.[272]

6. Evaluation of Puerto Rico's Political and Economic Condition: The CBI Model

For the most part, Caribbean nations have sought to avoid the problems of the Puerto Rican model by adjusting their economies to prevent foreign domination and its exploitation.[273] In fact, United

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(NPP), and the independence alternative by the Partido Independentista Puertorriqueño (PIP). *See* García-Passalacqua, *supra* note 22, at 276; *see also* Tansill, *supra* note 22, at 83-95 (discussing the historical development of political parties in Puerto Rico and the rise of the PDP and the NPP).

Since Puerto Rico's establishment as a commonwealth, power has shuttled between the commonwealth party and the statehood party. In recent elections, the commonwealth and statehood parties have received virtually equal percentages of the vote, with swing votes provided by the independence party. A. Payne, *supra* note 2, at 17-18; García-Passalacqua, *supra* note 22, at 273, 276.

The Puerto Rican people can see little advantage in changing their status, since economic and political conditions under either statehood or independence are only speculative. *See, e.g.*, Rivera, *supra* note 95, at 167-81. Many Puerto Rican leaders envision economic chaos should section 936 be repealed. *See supra* notes 124-28 and accompanying text.

[270] *See* Commission Report, *supra* note 266, at 8.

[271] Costas Elena, pt. 4, *supra* note 89, at 649.

[272] *See A Bad Idea Worries Puerto Rico*, N.Y. Times, May 13, 1985, at A18, col. 1.

[273] *See* Braveboy-Wagner, *supra* note 16, at 166-67. Braveboy-Wagner describes the reasoning by which Third World leaders rejected foreign domination of their economies:

> [I]t was realized that uncontrolled capitalism generated . . . foreign domination of Third World economies and excessive dependence on external forces with a subsequent subrogation of political power; decapitalization by foreign private enterprise; an increase in imports with adverse affects on the balance of payments; the decline of agriculture with the growth of industry and urbanization; rising unemployment as people moved to the cities while capital-intensive industries and those with limited opportunity for expansion failed to produce enough jobs; more urban crime; and a widening of the gap between the elites and the masses, city and country-

States scholars have rejected the Puerto Rican model as a pattern for development of the CBI.[274] Instead, economic independence is being fostered through joint ventures,[275] trading companies[276] and subcontracting. These structures ensure the commitment of the CBI country to the success of the ventures, and also reduce the risks for the United States corporation. In addition, CBI countries can pursue investment opportunities with trading partners other than the United States.[277]

Puerto Rico is essentially restricted from the same opportunities which the CBI seeks to promote. As indicated above, the United States discourages Puerto Rico from soliciting investment from other foreign countries.[278] Furthermore, even though the Twin Plant Program encourages joint ventures, the joint venture occurs between a Caribbean Basin corporation and a United States corporation, rather than between a Caribbean Basin corporation and a Puerto Rican corporation. Unless Puerto Rico can achieve some level of economic independence from the United States, any benefits to Puerto Rico in the Caribbean Basin apart from those emanating from the United States will be short lived.

Rather than allow Puerto Rico to continue to suffer under a rejected development model, the United States must fashion a new model

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side, and workers and management.

Id. at 167.

[274] *See Hearings on the CBI*, *supra* note 66, at 49 (statement of Richard Weisskoff); *see also Review of the CBI*, *supra* note 2, at 459 (statement of Stuart K. Tucker, Fellow, Overseas Development Council) (stating that "the CBI will have a minimal effect, and the effects will be slow in coming").

[275] *See* Pastor, *supra* note 2, at 1047 ("[J]oint ventures . . . would be the best way to guarantee both investments and good relations in the long term and also help the local private sector."); *see also id.* at 1056 (emphasizing the importance of joint ventures to reduce the possibility of Caribbean nations becoming economically dependent on United States industry). The CBI is currently promoting the joint-venture concept, and should continue to do so. *See* GUIDEBOOK, *supra* note 6, at 3 ("The CBI also is creating opportunities for direct involvement by United States firms in joint ventures, subcontract manufacturing, technology licensing and other types of offshore operations."); *CBI Business Opportunities*, 3 CBI BUS. BULL., Dec. 1986, at 2-3 (virtually all CBI business opportunities described in that publication were in the form of joint ventures or subcontracts).

[276] Trading companies would help numerous small Caribbean nations "characterized by many small manufacturers and farmers who will never be large enough to handle export marketing." A trading company could consolidate the economic power of these small entrepreneurs to create a comparative advantage for the country as a whole. ENGLISH-SPEAKING CARIBBEAN, *supra* note 2, at 27.

[277] Pastor, *supra* note 2, at 1056 (stating the importance of foreign investment and trade incentives). United States investors should also be aware of other nations' preferential treatment of Caribbean Basin nations and use these preferences to structure an export base in the Caribbean through which they can export to countries under other preferential schemes. The United States could then cooperate with other nations to ensure the success of economic growth and development in the Caribbean Basin. *See* DELEGATION MISSION REPORT, *supra* note 12, at 43.

[278] *See supra* note 243 and accompanying text.

to once again assure Puerto Rico's place as the "Shining Star of the Caribbean."[279] The section 936 investment incentives and the Twin Plant Program, however, necessitate the continuance of section 936 for at least the duration of the CBI.[280] Moreover, supporters of section 936 argue that the program has never been given a chance to work for any number of years without either Congress or the Treasury Department tampering with it.[281]

One of the main problems with replacing section 936 with a better alternative is that all attempts by the United States Treasury Department and congressional committees to do so have been hurried, based on faulty economic data, and so ineffective that Puerto Ricans have had no choice but to request the continuance of the status quo.[282] In order to ensure Puerto Rico economic and political stability, however, the United States should begin to wean Puerto Rico from economic dependence on the United States. Local Puerto Rican industry, rather than section 936 investment, should be fostered and encouraged, particularly within the Twin Plant Program. Puerto Ricans would then feel more committed toward the success of their island's economic development, rather than constantly relying on the United States to solve their economic problems. The United States should also support investment by other countries in Puerto Rico, and perhaps even encourage Puerto Rican participation in trading organizations. Finally, the continuation of section 936 should be carefully analyzed, not from the perspective of United States tax losses, but from the perspective of Puerto Rico's economic problems.[283] Moreover, should a consensus to eliminate section 936 be reached, the transition should be designed to be as trouble-free as possible for Puerto Rico. Ways to continue to encourage investment while eliminating the investment incentive should include a long phaseout period that would limit investment attrition from the island, continuation of Puerto Rico's involvement in the CBI, and assistance to Puerto Rican officials in the formulation of their own investment

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[279] *See* Martin, *supra* note 56, at 9.

[280] *See Comprehensive Tax Reform, Part 6*, *supra* note 9, at 5044 ("[I]f 936 goes, the whole twin-plant financing scheme also goes.").

[281] *See* Culpeper, *supra* note 102, at 69 (proposing a 5-10 year moratorium on further changes in § 936).

[282] The attempt to shift to a wage credit in 1984-85 was one such fiasco. In short, much more time, research and analysis must go into any decision to replace a section of the Internal Revenue Code which has been in existence for over half a century and upon which 3.3 million United States citizens rely. *See supra* notes 117-28 and accompanying text.

[283] *See* Costas Elena, pt. 4, *supra* note 89, at 661-66. Costas Elena believes that, since the Puerto Rican Government is either unwilling or unable to reform § 936, the United States Government should do so. *Id.*

incentives.

Because Section 936 is linked to the continuation of Puerto Rico as a Commonwealth, the United States should also take a more active role with regard to Puerto Rico's political status. A referendum should be called to determine the present sentiments of the Puerto Rican people. The results will then be used to structure a program of steering Puerto Rico slowly but stably toward a less dependent form of government.[284] This referendum should assure the Puerto Rican people that, no matter what the outcome, a gradual transition would occur, accompanied by a United States commitment to continue aid for a stated period of time. For it is only when Puerto Rico is economically and politically independent that it will be able to determine its future status.

7. Conclusion

"For reasons of security, economics, and morality, United States policy-makers should conceive of Puerto Rico as an essential element in the long-range stability of the Central American and Caribbean community."[285] The United States has recognized the similar historical and economic background shared by its Commonwealth of Puerto Rico and the other nations of the Caribbean Basin.[286] Consequently, in the Tax Reform Act of 1986, the United States has allowed Puerto Rico to interact with the CBI nations to promote the Twin Plant Program, a private investment development plan which fosters both economic growth and regional integration.[287]

The United States must realize that section 936 and the Twin Plant Program are not cure-alls for Caribbean economic development; fundamental Caribbean problems such as political instability, inadequate infrastructure, and reluctance to diversify production into non-traditional exports may persist despite United States' efforts to solve them. The United States must be careful, however, not to replicate the Puerto Rican example of economic dependence in other Caribbean Basin countries.[288] Therefore, efforts to encourage economic independence

[284] *See* García-Passalacqua, *supra* note 22, at 292-94.
[285] *Id.* at 293.
[286] *See supra* notes 17-35 and accompanying text.
[287] *See supra* Section 3.2.2.
[288] In order to avoid replicating the mistakes made in Puerto Rico, assembly operations could be deemphasized and agricultural development and local industry promoted. *See* Pastor, *supra* note 2, at 1051 ("[A]ssembly operations alone not only foster dependence, they also miss valuable development opportunities to multiply investment."). Furthermore, continued efforts must be made to deal with the fundamental problems of the region through joint ventures with local investors rather than by simply overwhelming the area with outside capital furnished by United States investors. *See* Boodhoo, *supra* note 2, at 89 ("It is then, and only then, that the United States will

through joint ventures and multilateral trade preferences must be continued.[289] Additionally, the United States must remember that economic stability must be the focal point for Caribbean Basin policy,[290] because it is through economic stability that political stability is fostered.[291]

Although aid to the Caribbean Basin should be continued, especially to countries with poor infrastructures, increasing emphasis should be placed on the trade and private investment provisions of the CBI. Additional incentives should be given to investors committed to building plants in less stable couuntries, and to those willing to produce new non-traditional products for export. In particular, local Caribbean investment and innovation should be encouraged, and every attempt should be made to limit protectionist statements among United States government officials. Recent Congressional efforts to amend and improve the CBI should be continued.

Above all, the United States cannot lose focus of the economic and political problems of Puerto Rico as the United States moves forward with its Caribbean policy. The interrelationship between Puerto Rico's Commonwealth status and section 936 fosters economic dependence. Therefore, a new model must be developed to promote local Puerto Rican industry and further Puerto Rican autonomy. The United States must proceed with care, however, since recent attempts to uproot the established economic system have been met with stiff resistance from Puerto Rican leaders.[292] Careful research must go into any decision to alter Puerto Rico's economic position to ensure the continued political stability of the island.

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contribute to developing rather than exploiting the Caribbean Basin.").

[289] *See supra* notes 273-77 and accompanying text.

[290] *See* Harrison, *supra* note 35, at 43.

[291] *See supra* note 57 and accompanying text.

[292] *See supra* notes 117-28 and accompanying text.